Calling a Change in the Outsourcing Market
The Realities for the World’s Largest Organizations
April 2005
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While outsourcing has become a dominant trend, emerging evidence indicates that results have been mixed, and there are few in-depth studies that can help senior executives recognize the inherent complexities and common pitfalls of outsourcing. Deloitte Consulting LLP conducted a study to help fill this gap and provide a fresh point of view on outsourcing.


Nearly half of the participants are part of the Fortune 500; one-fourth are privately held or public sector entities and four are headquartered outside the United States. Six are part of the Fortune 50, and three are ranked in Fortune Global 100.

Approximately three-fourths of the participating organizations are listed on the New York Stock Exchange or NASDAQ.

Ten participants are members of the Dow Jones Composite Index and/or the Standard & Poor's 500.

These organizations represent a combined market capitalization of nearly 1 trillion USD, employing more than 1 million workers. They spend a combined 50 billion USD on their large outsourcing contracts alone.

The average participant has annual revenues of 50 billion USD, operating expenses of 13 billion USD, market capitalization of 53 billion USD, and approximately 60,000 employees.

Two notable academics, Dr. N. Venkatraman (Boston University) and Dr. Eric Clemons (University of Pennsylvania, Wharton School of Business), also participated in the study. The study was conducted in-person during October – December 2004 with senior executives who have both decision-making and operational authority in outsourcing in their organizations.

Comments contained in the findings and analysis that follow have not been attributed to study participants to maintain confidentiality. Not all participants answered all study questions.

Throughout this document, the words “companies” and “organizations” have been used interchangeably to denote entities outsourcing business functions. Outsourcing providers are denoted as “vendors.”

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Calling a Change in the Outsourcing Market

Organizations have now begun to recognize the real costs and inherent risks of outsourcing. Instead of simplifying operations, outsourcing often introduces complexity, increased cost, and friction into the value chain, requiring more senior management attention and deeper management skills than anticipated. In addition, outsourcing has allowed organizations to transfer financial and operational risk to vendors, but organizations are discovering that their contracts will never fully protect them against customer damage and business losses caused by service disruption. Many have responded by bringing operations back in-house and by exploring alternatives to traditional outsourcing, such as the Transform-Operate-Transfer model.

Executive Summary

The world’s largest companies have engaged in outsourcing for a variety of reasons: to reduce costs, expand capabilities, and increase flexibility. However, contrary to the optimistic portrayal of outsourcing by vendors and the marketplace, outsourcing is an extraordinarily complex process and the anticipated benefits often fail to materialize.

“Based on the evidence from our research, Deloitte Consulting is calling a change in the outsourcing market.”

The outsourcing of services requires a complex series of trade-offs: cost savings versus growth, speed versus quality of service delivery, and maintaining organizational cohesion versus knowledge and innovation. Vendors and organizations have inherently conflicting objectives, putting the latter’s objective for innovation, cost savings, and quality at risk.

Moreover, the vendors’ structural advantages do not always translate into cheaper, better, or faster services. The world’s largest companies should be able to replicate the vendors’ structural advantages in-house and rely on vendors only under specific circumstances, such as fixing deep-seated structural problems or maintaining infrastructure operations.

Outsourcing originated and became popular as a cost-saving strategy during a recessionary environment. The world’s largest organizations in this study are calling into question its efficacy in today’s economy.
In today's economy and labor market, organizations looking for differentiated growth solutions should avoid outsourcing when based solely on cost savings. Many organizations have been compelled to adopt outsourcing to improve their technical, operational, and process management skills. However, companies should outsource only commodity functions to guard against a loss of knowledge and should plan for short-term outsourcing to prevent vendor dependency. Demanding transparency to costs, negotiating for simplicity to eliminate hidden charges, and actively managing against service disruptions may improve the outsourcing experience for large companies…but in turn they also will increase the time needed to manage the complexity and costs of these arrangements.

In the near future, with structural risks that cannot be fully mitigated, uncertain cost savings, and a multitude of components to manage (people, process, and knowledge), outsourcing will likely lose luster for large organizations.

An unfavorable mix of rising costs and increased demand will drive up the cost of outsourcing for organizations and vendors. Weaknesses in operational management will result in more deal failures, prompting organizations to bring more operations back in-house. In the long run, organizations that continue to outsource will experience a loss of bargaining power to vendors as the supply side consolidates.

Those that apply strong skills in deal structuring and risk management and strong management skills to oversee deals from inception to execution will be best positioned to reap the benefits of outsourcing. Deloitte Consulting’s point of view is that outsourcing will remain a useful solution within the conservative context of five models: Centralize-Standardize-Outsource, Transform-Operate-Transfer, Commodities Outsourcing, Risk Transfer (“Insurance”), and Shifting Fixed Costs to Variable Costs.

“In the near future, with structural risks that cannot be fully mitigated, uncertain cost savings, and a multitude of components to manage, outsourcing will likely lose luster for large organizations.”
Market Situation

- In the real world, outsourcing frequently fails to deliver its promise.
- Rising negative sentiment in the media, analysis of a sample of 50 problem deals, and other surveys prove that the tide is turning in the outsourcing market.
- Large organizations are managing margins and demanding more from vendors, but large-scale insourcing and reduced choice of providers will erode the allure of outsourcing.
Calling a Change in the Outsourcing Market

The Rationale for Outsourcing Is at Odds with Market Experience

Each participant named at least one of the items below as a major driver of the outsourcing decision. However, in many cases, the participants’ outsourcing experiences have not measured up to their expectations.

<table>
<thead>
<tr>
<th>Reason</th>
<th>Percentage</th>
<th>Notes</th>
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</thead>
<tbody>
<tr>
<td>Cost Savings</td>
<td>70%</td>
<td>...but 38% of these participants have paid additional/hidden costs for services they believed were included in their contracts</td>
</tr>
<tr>
<td>Best Practices/Quality/Innovation</td>
<td>57%</td>
<td>...but 31% of these participants stated vendors became complacent once contracts were in place</td>
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<tr>
<td>Flexibility/Capacity/Scalability</td>
<td>35%</td>
<td>...but commentary revealed that outsourcing adds a level of rigidity because contracts are binding and vendors may choose not to accommodate last-minute changes or requests</td>
</tr>
<tr>
<td>Focus on Core/Strategic</td>
<td>35%</td>
<td>...but 1 in 4 of these participants had mislabeled functions as non-strategic and ultimately brought those thought leadership areas back in-house</td>
</tr>
<tr>
<td>Access to High-Caliber Labor</td>
<td>22%</td>
<td>...but 1 in 5 of these participants experienced greater than expected vendor employee turnover and realized the knowledge base they had paid for was fleeting</td>
</tr>
<tr>
<td>Transfer Risk to Vendor</td>
<td>22%</td>
<td>...but commentary revealed that vendors are unable to fully absorb the costs of business losses, leaving the organization responsible for paying the bill</td>
</tr>
<tr>
<td>Lack of Expertise In-House</td>
<td>16%</td>
<td>...but 44% of these participants found that their vendors did not have the capabilities to provide the expected level of quality and cost savings, resulting in the participants’ decision to bring operations back in-house</td>
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</tbody>
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*Participants were not limited to one answer

Source: Deloitte Consulting Outsourcing Study, October-December 2004

In the Real World, Outsourcing Frequently Fails to Deliver Its Promise.

“The world’s largest companies should be able to replicate the vendor’s structural advantages in-house and rely on vendors only under specific circumstances.”
Rising Negative Sentiment in the Media, Analysis of a Sample of 50 Problem Deals, and Other Surveys Prove that the Tide Is Turning in the Outsourcing Market.

Negative articles are outpacing the positive.

- 30 percent more anti-outsourcing articles (55) than pro-outsourcing (42) ones were published in 2004.\(^1\)
  - For the first time, the number of anti-outsourcing articles has surpassed the number of pro-outsourcing articles in the six sampled publications.

- In a 2004 LexisNexis\(^\circledast\) search, occurrences of 13 stock phrases\(^2\) denoting negative outsourcing sentiment exceeded all such occurrences in the last five years combined.

In the past eight years, 38 of 50 randomly selected problem deals, totalling more than 25 billion USD, resulted in litigation or termination.

- From the sample of 50 problem deals, 74 percent failed due to vendor underperformance and/or cost overruns.

- Of the 33 deals in the sample for which the timing is known, one-third failed in the first year, and 50 percent in the first five years.

Other surveys also debunk the optimistic portrayal of outsourcing by vendors.

- A Dun & Bradstreet Survey\(^3\) shows 20 percent of outsourcing relationships fail in the first two years, and 50 percent within five years.

- A DiamondCluster International Survey\(^4\) shows that 78 percent of responding executives had to terminate agreements early due to poor service, a change in strategic direction, or costs.

- A PA Consulting Group Survey\(^5\) of executives at 116 organizations in Europe, North America, and Asia shows that:
  - 66 percent reported that business benefits were either only “partially” realized or not delivered at all.
  - More than half (55 percent) of benefits rated as “highly important” had not been fully realized.
  - 15 percent of respondents were thinking of bringing services back in-house.
Large Organizations Are Managing Margins and Demanding More from Vendors, but Large-Scale Insourcing and Reduced Choice of Providers Will Erode the Allure of Outsourcing.

Faced with unfavorable outsourcing economics and rigidity, organizations are insourcing and renegotiating to regain control, negatively impacting their human resources and supply chain strategies.

- 83 percent of the participants renegotiated their contracts in response to changes in prices and to the business, technology, or regulatory environment.
  - 17 percent cited loss of flexibility as a major risk introducing rigidity and friction into the organizational value chain, thus impacting corporate growth and the speed and quality of service delivery.

- Large-scale insourcing and/or renegotiation require significant senior management commitment, diverting attention from core business functions.
  - Organizations need to train or hire experienced managers with superior negotiation skills.
  - Re-integrating outsourced business functions requires hiring knowledgeable staff and often changing human resources practices.
  - High vendor turnover and changing conditions for service delivery often forces companies to modify their supply chain procedures, adding complexity.

Greater price transparency will result in lower vendor margins, making outsourcing a less attractive option and compelling the vendors to reposition their best resources to other growth opportunities.

- 81 percent of the participants, when queried, said that they had limited or no transparency to vendor pricing and cost structure. However, 60 percent of participants desired to learn more about vendor costs.
  - Approximately one-third of the participants who have transparency felt that vendor margins may decrease in the future.
  - Commentary suggested that the procurement power of large buyers will motivate vendors to provide more price transparency.

- Faced with rising instances of deal failure, both vendors and organizations will become more selective about entering into outsourcing contracts.
  - A notable academic expert commented that “the era of big deals is over.”
  - “IBM is shifting to technology service contracts that are shorter and smaller in scope than its big traditional outsourcing deals.”

- “Switching cost” and lack of choice in selecting vendors will compel organizations to exercise caution when planning outsourcing.

- As outsourcing contracts become less profitable, vendors will steer their investments and best resources to other, more lucrative opportunities.
  - “Vendors are not always ready to take on the next clients. If their profitability is threatened the vendors may declare they are under duress, demand ransom, and then cut services to improve profitability on other deals.”

Have You Brought Any Outsourced Services Back In-House?

| Yes 64% | No 36% |

Source: Deloitte Consulting Outsourcing Study, October-December 2004

“Vendors and organizations have inherently conflicting objectives.”
• Outsourcing generates fundamental risks and concerns, more than half of which are structural and cannot be fully mitigated.

• Companies are concerned about intellectual property and confidentiality risks, loss of institutional knowledge, and loss of control over outsourced functions.

• Outsourcing often reduces an organization’s responsiveness to market changes and poses internal political, organizational, and cultural challenges.

• Structural risks shift bargaining power to the vendors, while contracts often provide limited protection.
Outsourcing Generates Fundamental Risks and Concerns, More than Half of Which Are Structural and Cannot Be Fully Mitigated.

Companies are exposed to fundamental outsourcing risks and are facing go/no-go challenges as new risks emerge.

- 45 percent stated that an organization should not outsource processes that it does not fully understand. Two participants emphasized that outsourcing without fully understanding the organization’s processes and cost structure is extremely risky because the organization will not know what to demand from vendors and how much to pay.
  - 1 in 4 participants brought back functions after realizing that they can do it better and/or at lower cost in-house.

- 10 percent of participants expressed concern about limited transparency and an increased lack of control due to vendors’ subcontracting.

- Global companies often are unable to find global vendors to provide standardized services across the different regions, driving them to employ multiple vendor relationships or scale back outsourcing objectives.

- 17 percent of participants mentioned the new Sarbanes-Oxley requirements as an added layer of complexity to the already difficult governance of outsourcing deals, creating a new unexplored risk frontier.

Outsourcing increases the risks of intellectual property violation and loss of confidentiality.

- 26 percent of the participants view intellectual property and confidentiality issues as leading risks of outsourcing.
  - Outsourcing IT infrastructure such as IT Systems Administration allows vendors to access confidential business information.
  - “It’s important to keep intellectual capital close to the chest.”

- 10 percent of the participants experienced confidentiality and intellectual property rights violations.
  - One participant discovered its vendor selling its proprietary software to other clients.
  - However this is a tough risk to mitigate: “This is very troubling, and I have to constantly keep a watch on my vendors.”

Loss of control over outsourced functions poses a substantial threat to ongoing operations.

- 30 percent of the participants viewed loss of control over outsourced functions as a substantial risk.
  - “Avoid outsourcing ‘lock, stock, and barrel,’ in order to maintain control (over our value chain).”

- Participants are bringing outsourced functions back in-house because they realize they have lost control over critical processes.
  - “Too much outsourcing results in lack of control. Companies should not outsource key areas where losing control can be disastrous.”

The risk of losing institutional knowledge is greater when outsourcing “thought leadership” functions and can be partially mitigated by outsourcing only commodity processes.

- 30 percent of the participants view the loss of institutional knowledge as a leading risk of outsourcing.
  - “We came up with a rule: If it is a ‘rule-based’ process, it can be outsourced; if it is a ‘decision-based’ process, it is not to be outsourced.”

- Nearly 20 percent of the participants outsourced functions they later recognized as “thought leadership” and containing imbedded strategic knowledge, acknowledged their mistake, and brought operations back in-house.
  - “Now that we are bringing the function back in-house, we are dependent on vendor cooperation to transfer the knowledge.”
Outsourcing Often Reduces Organizations’ Responsiveness to Market Changes and Poses Internal Political, Organizational, and Cultural Challenges.

Multi-year contracts result in a loss of flexibility to react to market changes, hurting companies’ competitiveness.

- 1 in 6 participants are concerned about the loss of flexibility to react to changes in the market (e.g., competitive, regulatory), as a result of being locked into multi-year deals.
  - Vendors push for long-term deals to recoup initial investments and make profits. When pressed to shorten deal length, prices increase.
  - “We buy flexibility with shorter term deals, even though they are clearly more expensive.”
  - There is an explicit trade-off between maintaining flexibility and lowering cost.
  - “…circumstances change, and we can’t afford to get locked into a bad deal.”

Outsourcing negatively impacts organizational cohesion by posing political, organizational, and cultural challenges in all stages, from decision-making through implementation.

- 1 in 4 participants have struggled with internal politics and conflicts surrounding their outsourcing decisions.
- 1 out of 6 participants identified employee backlash and active labor unions as substantial obstacles.
  - “Employees are never going to accept outsourcing. It will be their choice to stay or leave.”
- 40 percent of the participants dealt with organizational challenges that follow outsourcing, primarily reorganizing roles and responsibilities and raising the skill sets of the retained organization.
  - “Managers who were trained to run day-to-day operations now need to learn to manage results and vendors.”
  - Companies must take into account the “significant amount of time it takes for employees to get accustomed to changes.”
Structural Risks Shift Bargaining Power to the Vendors, While Contracts Often Provide Limited Protection.

Structural risks lead to a shift of bargaining power from the organization to the vendor.
• 1 in 5 participants have explicitly identified the loss of bargaining power as a major outsourcing risk.
  – Handover of control and knowledge to the vendor creates an ongoing dependency on the vendor. This dependency ultimately shifts power to the vendor and weakens the organization.
  – Once an organization has gone through the process of adjusting its retained organization and its skill sets, it no longer holds the capabilities and skill sets to manage these functions in-house, increasing dependency on the vendor.

Long-term contracts and proprietary systems further increase vendors’ bargaining power.
• Long-term contracts (six-ten years) substantially increase the risk of shifting bargaining power to the vendor.
  – “We don’t do a lot of outsourcing because the vendors are hung up on long-term commitments, like 5 years. They are putting a large investment, so they need the long term, but that's quite a leap of faith, putting yourself in the hands of someone for 5 years.”
  – “...once you hand over maintenance it's not easy to take it back.”
• Vendors might lock companies into using proprietary systems, making it difficult to switch vendors in the future.
  – One participant reported changing its vendor on a large infrastructure contract when it observed that the vendor was trying to gradually integrate it into proprietary systems.

Organizations are trying to offset this trend by negotiating shorter-term, more flexible contracts and by working with multiple vendors.
• 53 percent of the participants have moved from long-term contracts (6-10 years) to shorter contracts (up to five years). None of the participants that currently have long-term contracts expect them to go to full-term.
• 73 percent of the participants are working with multiple vendors. Participants that had exclusive deals in the past warn that they are extremely risky and that they will never enter into them again.
  – “My vendors always know that they could lose the business any day, or there is more business to win every day—they make the choice; our vendors have to earn our business every day.”

However, these mitigation strategies provide limited protection.
• Even short-term deals (less than three years) often create high dependency on vendors, holding organizations captive.
• “Second sourcing” (wherein two outsourcers provide services to forestall monopoly pricing power) is difficult with services outsourcing. Multi-vendor models increase the level of complexity, requiring additional resources from the organization.
• Vendor dependency cannot be fully mitigated because the organization no longer owns the functions, knowledge, people, and systems.

And, organizations then find themselves trapped in deals with higher rates and low-quality delivery.
• The vendor’s bargaining power becomes evident in contract renegotiations or renewals, and the organization is forced to adhere to the vendor’s terms or incur high switching costs. Specific consequences that were mentioned:
  – Being trapped in a deal with above-market rates
  – Diminishing service standards
• Four participants indicated that vendors force contract renegotiation to increase their profitability, leading to higher rates.
Calling a Change in the Outsourcing Market

Outsourcing, which originated as a popular cost-saving strategy during a recessionary economic environment, is still dominantly driven by cost-related objectives and the perception that organizations benefit from vendors’ economies of scale.

However, evidence of tailored deals and in-house economies of scale at large organizations suggests that vendors’ scale advantages may be illusory.

Lack of transparency, bundling of services, and a variety of marketing techniques have created suspicion about the savings from outsourcing.

Real-world experiences suggest that the potential for cost savings has been overstated.

Costs

• Outsourcing, which originated as a popular cost-saving strategy during a recessionary economic environment, is still dominantly driven by cost-related objectives and the perception that organizations benefit from vendors’ economies of scale.

• However, evidence of tailored deals and in-house economies of scale at large organizations suggests that vendors’ scale advantages may be illusory.

• Lack of transparency, bundling of services, and a variety of marketing techniques have created suspicion about the savings from outsourcing.

• Real-world experiences suggest that the potential for cost savings has been overstated.

Recent surveys suggest that outsourcing is no longer driven primarily by cost, but instead by the desire to gain expertise and increase quality.

- A 2004 The Earth Institute/Columbia University outsourcing study found that 62 percent of the companies surveyed are outsourcing because of a desire to improve the quality of services.8

- A 2004 Bureau of National Affairs survey of human resources outsourcing found that gaining access to greater expertise (69 percent) and improving service quality (44 percent) are the top two reasons to outsource. Only 28 percent of respondents mentioned cost-cutting as a main driver.9

However, our findings suggest that outsourcing is still highly driven by cost savings objectives...

- 83 percent of participants mentioned cost savings as an expected benefit of outsourcing.

- 70 percent of participants cited cost savings as one of the key drivers of outsourcing.

- 43 percent of participants declared cost savings as the primary criterion for choosing a vendor.

...And that organizations believe cost savings are delivered mostly through vendors’ economies of scale.

- Vendors can leverage highly specialized resources and infrastructure, giving the organizations the flexibility to scale up and down rapidly.

- In addition, vendors have economies of scale in knowledge, which allow them to:
  - Add value to the organizations by providing access to new ideas
  - Provide cheaper services, even after factoring in profit margins

![Vendors' Perceived Structural Advantages](source: Deloitte Consulting Outsourcing Study, October-December 2004)
However, Evidence of Tailored Deals and In-house Economies of Scale at Large Organizations Suggests that Vendors’ Scale Advantages May Be Illusory.

Large outsourcing deals are typically “tailored,” eliminating the vendors’ ability to standardize contracts to deliver economies of scale.

- 100 percent of participants have tailored outsourcing deals.
  - Vendors find it difficult to offer standardized services to complex organizations.
  - As the need to tailor contracts increases, the vendor’s ability to deliver savings based on economies of scale decreases.
  - “If a project needs customizing, it should not be subject to outsourcing.”

It is uncertain that there are economies of scale to be gained by large organizations that already realize some economies of scale in-house.

- 48 percent of participants agreed or partially agreed that few vendors (except infrastructure vendors) have economies of scale greater than those of large companies.
- 43 percent of participants agreed or partially agreed that large, well-run companies have resources, both technical and managerial, to efficiently run outsourced functions themselves.
  - “The benefits of the economies of scale argument are relative. Fortune 100-300 IT departments may benefit more from economies of scale in IT at large IT outsourcing vendors than those at Fortune 50.”

- Uncertain gains from vendors’ economies of scale suggest that additional cost savings may not be enough to counter the risks of outsourcing.

How Standardized or Tailored Are Your Outsourcing Deals?

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<tr>
<th>How Standardized or Tailored are Your Outsourcing Deals?</th>
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<tbody>
<tr>
<td>Tailored 76%</td>
</tr>
<tr>
<td>Some Standardized/Some Tailored 24%</td>
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Note: Seventeen percent of the participants indicated a shift toward more standardized agreements (terms and conditions, legal, etc.)

Source: Deloitte Consulting Outsourcing Study, October-December 2004
Lack of Transparency, Bundling of Services, and a Variety of Marketing Techniques Have Created Suspicion about the Savings from Outsourcing.

Limited transparency to a vendor’s pricing and cost structure makes it difficult to understand cost savings.
- 81 percent of participants have limited or no transparency to a vendor’s pricing and cost structure.
  - “We have encountered occasional hidden costs and to improve transparency, we pit vendor against vendor.”
- Typical vendor responses to pricing transparency inquiries included:
  - “We never ask how you price your services.”
  - “You will never see our numbers.”

Transparency to a vendor’s costs decreases as outsourcing contracts are bundled with other services.
- Of the 70 percent of participants with outsourcing contracts bundled with other services, 45 percent recognize bundling issues and restrictions.
  - Bundling makes it difficult for organizations to discern unit costs and complicates business cases.
  - Bundling allows financial engineering that hides the true economics of the deals.

Vendors employ marketing techniques that can create illusory cost savings.
- Under-market pricing is common due to fierce competition among vendors.
  - Vendors undertake contracts that are not economically viable for them, especially with early mega-deals or strong brand entrants.
  - “There is a significant value in having us as a client. I do not know how the vendors make their money, but they are factoring in a benefit for having our account.”
- Re-pricing issues start to emerge when vendors attempt to recoup their margins as relationships mature.
  - “After two years of contracts, the costs go ballistic; teaser rates are all over the place.”
Real-World Experience Suggest That the Potential for Cost Savings Has Been Overstated.

Organizations are becoming aware of cost-related risks.
• 52 percent of participants ranked cost-related issues as the main risks of outsourcing.
• 42 percent of the cost-related risks correspond to hidden costs and/or transparency.
  – “Vendors give clients better deals until years three or four; after that they begin exploiting the clients.”

And are experiencing hidden costs.
• 50 percent of participants identified hidden costs as the most common problem when managing outsourcing deals.
• 44 percent of participants did not see cost savings materializing.
• 50 percent of participants with limited or no transparency have paid additional costs in their outsourcing relationships.
• 57 percent participants have paid additional costs for services they thought were included in the contract.
  – “Unexpected costs are almost guaranteed. I have not executed any deal without them.”

After accounting for the vendor’s raw cost, contract administration, profit margins, and in-house management, outsourcing does not always make economic sense.
• 62 percent of participants realized that they require more management efforts in comparison to the original estimates.
• 57 percent of participants could not free up internal resources for other projects, leading to larger than anticipated deal management overhead. One participant reported a 300 percent larger retained organization than anticipated.
Organizational Complexity

- Participants recognize the need for improvement in decision-making, but attempts to standardize the business case, improve due diligence, and increase transparency often are not used for new contracts or are too late for existing contracts.
- Outsourcing relationships require substantially more recordkeeping, attention, and hands-on management than anticipated.
- Vendor complacency, employee turnover, unsatisfactory delivery resources, and unbalanced contracts have prompted organizations to increase their demands, and vendor management continues to pose challenges.
Participants Recognize the Need for Improvement in Decision-Making, but Attempts to Standardize the Business Case, Improve Due Diligence, and Increase Transparency Often Are Not Used for New Contracts or Are Too Late for Existing Contracts.

Participants have mixed levels of analytical preparedness, knowledge, and negotiating ability – resulting in a lengthy, problem-prone, and highly politicized decision-making process.

- 48 percent of participants do not have a standardized methodology to evaluate the business case for outsourcing.
- 26 percent indicated a need for different skills, with greater emphasis on negotiation, relationship development, and maintenance.
  - Existing management that organizations predominantly rely on to drive the outsourcing process faces a complex set of factors – balancing operational improvement, contract management, capital expenditure, human resources dynamics, and developing new metrics and multi-year cost-reduction targets with vendors – the sum of which are often outside the realm of their experience.
- 24 percent stated the outsourcing decision, from business case to procurement, is a very lengthy process, ranging from six months to two years to complete.

Participants are standardizing decision-making methodologies and demanding more transparency, but these changes are often not used for new contracts or are too late for existing ones.

- 27 percent of participants indicated a shift toward a more standardized business case for future decisions; however, they realize that standardization will be difficult because they have limited experience with outsourcing.
- 33 percent recognized a need for a more complete due diligence process.
  - “We have increased the level of up-front due diligence – not just cost baseline, but delivery and qualitative outcomes.”
- Half of the participants with limited or no knowledge of their vendors’ pricing structures are demanding more transparency in an attempt to ensure proper vendor selection.
- All of these efforts result in changes to the governance process and future deals, but do not affect the contracts that are already in place, raising the spectre of unknown and future problems in managing their current portfolio of deals.

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<th>What Methods Are Used to Analyze and Justify the Decision to Outsource?</th>
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<td>Case-by-Case Analysis</td>
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<tr>
<td>No Formal Methodology</td>
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Source: Deloitte Consulting Outsourcing Study, October-December 2004

Managing outsourcing contracts and relationships is more difficult, more expensive, and more time consuming than anticipated.

- 62 percent of participants stated that managing outsourcing relationships requires more effort than anticipated.
  - “Everything takes longer than you plan.”
  - “Outsourcing has created more work for many of our people...more governance related to security issues and contractual dynamics...bad from a management perspective.”

- Participants manage contracts up to 10,000 pages in length, making the ability to check on vendor adherence to all contract clauses nearly impossible.

This leads to unplanned senior management involvement and up to a 300 percent larger retained organization than anticipated.

- Although 39 percent of participants expressed realignment of resources as a key benefit of outsourcing, 44 percent of those participants have yet to realize this benefit.

- 17 percent of the participants have added or are currently adding resources for relationship management and maintenance.
  - “Vendors make mistakes and we have to pick up after them.”

- Commentary revealed that because of insufficient due diligence, participants underestimate the number of resources and the effort required to manage the retained organization.

- 75 percent of participants described multi-layered governance structures and, of those participants, 42 percent have dedicated resources for each vendor relationship, further complicating reporting relationships.
  - Participants stated that often they dedicate too few resources to deal management and are later forced to develop larger vendor management teams that result in more complex, multi-layered governance structures.
Vendor Complacency, Employee Turnover, Unsatisfactory Delivery Resources, and Unbalanced Contracts Have Prompted Organizations to Increase Their Demands, and Vendor Management Continues to Pose Challenges.

Complacency, turnover, “average” delivery resources and vendor self-reported Service Level Agreements (SLAs) have often dictated the course of outsourcing relationships, stacking the deck in favor of the vendor.

- 1 in 5 participants stated that unless pressured, vendors become complacent and fail to provide innovative solutions and process improvements once contracts are in place.

- 22 percent experienced vendor employee turnover, leading to knowledge loss and interrupted service delivery.

- Three large participants noticed a significant difference in quality between their vendor’s “sales people” and “delivery people.”
  - While sales and marketing representatives perform well, the operations teams often perform at par or slightly above the level at which the organization previously performed the function.

- 1 in 10 participants indicated that subcontracting by vendors leads to an increased lack of control and creates a system in which accountability issues more readily arise.

- 1 in 7 participants expressed frustration with determining and measuring SLAs, and experiences have indicated that vendors can “twist the numbers” to protect themselves.

In response, participants have been forced to include gain-sharing incentives and more stringent quality and service requirements in their contracts.

- 45 percent of participants feel compelled to include gain-sharing clauses in contracts as motivation for innovation.

- 81 percent include provisions for regular updates and active involvement in governance meetings.

- Organizations are demanding better training and development programs for vendor employees, as well as increased investment in back office systems; the goal is to improve the retention of talent and decrease the likelihood of errors and service disruption.

These changes increase the total cost of the deal and do not provide protection against loss or leverage when managing “experts.”

- More stringent demands require more resources, time, and money – increasing the total cost of the deal.

- Metrics and contractual clauses meant to protect the organization often provide limited benefits.

- Organizations’ attempts to manage “experts” may not always be successful, as vendors have deeper domain expertise of the outsourced functions and are experts at structuring deals in their favor.

  - “I believe that 50 percent of outsourcing in the near future will be successful, with the failures stemming from clients that don’t know what they are doing, don’t understand outsourcing, or don’t understand their own business. Therefore, they don’t know how to structure and manage the deals.”
• Services outsourcing has evolved from product (manufacturing) sourcing, but fundamental differences have been overlooked and are coming to the fore.

• While 30 percent of participants have encountered normal outsourcing growing pains, 70 percent of participants have had significant negative experiences and are outsourcing with increasing caution and in a conservative manner.

• Outsourcing, as we know it, will increasingly lose luster. Vendors and organizations will become more selective about the deals they pursue.

• However, outsourcing will remain a useful solution within the conservative context of the following five models: centralize-standardize-outsource, transform-operate-transfer, commodities outsourcing, risk transfer, and shifting fixed costs to variable costs.

Conclusions
Services Outsourcing Has Evolved from Product Sourcing, but Fundamental Differences Have Been Overlooked and Are Coming to the Fore.

Measuring quality is standardized in product sourcing, yet it is tricky in services outsourcing.

Product (Manufacturing) Sourcing
- Products are tangible; therefore, measuring quality is more straightforward and standardized:
  - Predetermined quality standards (such as works/does not work, deviation from size).
  - Defined measures (such as x percent defects per batch).

Services Outsourcing
- Services are intangible, making it more challenging to measure quality.
- 91 percent of participants have SLAs in place. There is a trade-off between qualitative and quantitative metrics. Qualitative metrics are difficult to implement; therefore, companies resort to quantitative ones, which often fail to measure true quality.

Outsourced services are highly interdependent...

Product (Manufacturing) Sourcing
- Products are discrete by nature, and interdependencies are fewer and well defined.

Services Outsourcing
- Services are a continuum and have many interdependencies. These interdependencies are difficult to maintain when outsourced, leading to “blind symphony” (a condition created when too many organizational processes are outsourced and the organization is unable to function cohesively).

...Requiring tight ongoing cooperation with vendors.

Product (Manufacturing) Sourcing
- Relationships typically take the form of supplier-buyer.
- Relationships with different suppliers are independent of one another.

Services Outsourcing
- The high interdependence of services requires closer working relationships with every vendor and among vendors, increasing the complexity of the relationships and requiring far more management resources than product outsourcing.

Second sourcing, while common in product sourcing, is unsuitable for services outsourcing, leading to higher dependency on the vendors.

Product (Manufacturing) Sourcing
- Second sourcing (using more than one vendor for the same product) is a common practice with product manufacturing:
  - As a contingency
  - To increase bargaining power vis-a-vis the vendors

Services Outsourcing
- Second sourcing is often unsuitable for services outsourcing, as a company would not benefit from having two vendors for services such as IT infrastructure or business functions.
- Relying on a single vendor per service, and the interdependencies among the different services, create high dependency on vendors for continuing operations.

The result: complexity in place of simplicity.

Product (Manufacturing) Sourcing
- Product sourcing simplifies the value chain, allowing companies to become developers, marketers, and managers of the supply chain.

Services Outsourcing
- Outsourcing several functions to simplify operations results in a reverse effect; it increases the number of deals and vendors, resulting in increased complexity in all stages of the value chain – from strategy to execution.
While 30 Percent of the Participants Have Encountered Normal Outsourcing Growing Pains, 70 Percent Have Had Significant Negative Experiences and Are Outsourcing with Increasing Caution and in a Conservative Manner.

30 percent of participants have encountered “normal” growing pains, but 43 percent of these are new to outsourcing and likely to have problems down the road.

- 30 percent of the participants expressed satisfaction or “normal” growing pains with outsourcing. These participants faced one or no problems, with the most common being internal challenges.
- 43 percent of these participants have just recently begun to outsource and it may be difficult for them to make an early, conclusive evaluation of their outsourcing experiences.

70 percent of the participants have had negative outsourcing experiences and have either revised or are revising their outsourcing outlook, strategies, and tactics. These are the more experienced organizations and they will continue to move forward with outsourcing but with increased scrutiny.

- 70 percent of participants have had unsatisfactory outsourcing experiences, encountering two to ten problems.
  - 52 percent encountered two to four problems.
  - 18 percent encountered five or more problems.
  - “Outsourcing has caused us to lose focus on our core business…it has been more of a distraction than a benefit!”
- 100 percent of participants that faced more than five problems have gone through insourcing.
  - Commentary revealed that the insourced functions are often run at a lower cost and higher quality.
- In two instances, participants were subjected to problem escalation provisions. In one case, litigation was pursued, and in the second case the vendor’s violations were used as leverage to improve contractual terms.

- Despite these problems, most participants intend to continue outsourcing and are implementing lessons learned from past deals:
  - Clear definition of core and strategic functions that are not to be outsourced to retain competitive advantage.
  - Short-term contracts with renegotiation and cancellation clauses, and with comprehensive SLAs in place, including both quantitative and qualitative metrics to maintain flexibility and avoid vendor complacency.
  - Working with multiple vendors to reduce vendor dependency.
  - A standardized process of planning and decision-making.
  - Realistically planning governance systems involving the vendors, and budgeting resources and time for deal management to minimize operational complexity.

![Problems Faced by Participants with Negative Experiences](image)

*Participants were not limited to one answer
Source: Deloitte Consulting Outsourcing Study, October-December 2004
Outsourcing, as We Know It, Will Increasingly Lose Luster. Vendors and Organizations Will Become More Selective About the Deals They Pursue.

Outsourcing will lose “holy grail” status.
- In the future, companies will not outsource because it is the latest management fad, and “it is the thing to do.”
- Vendors will become more selective in choosing new clients to avoid taking on “mess for less.”

Organizations will outsource less...
- Organizations will carefully define core, strategic, and “thought-leadership” functions and will keep those inhouse to retain knowledge, confidentiality, and control over key functions. Some organizations will decide to outsource only short-term using the Transform-Operate-Transfer model.
- As a result of outsourcing only “commodity processes” or outsourcing temporarily for a transformation, organizations will outsource a smaller percentage of their operating expenses.
- Many organizations will also engage in large scale reinsourcing thereby further eroding the outsourcing market.

...And more conservative outsourcing will erode vendor margins.
- Organizations’ attempts to manage margins and increase the level of caution when outsourcing will lead to shorter contracts and a squeeze on profit margins of large providers.
- Vendors will continue to rationalize services, cost structure, and pricing.
Calling a Change in the Outsourcing Market

However, Outsourcing Will Remain a Useful Solution Within the Conservative Context of These Five Models.

Centralize-Standardize-Outsource

• Initially, organizational processes that have been targeted for outsourcing are centralized and standardized, allowing the company to achieve efficiencies internally and to gain detailed management insights into processes and costs.

• Newly-achieved efficiencies allow visibility into potential outsourcing business cases.

• Increased management insight into the functions enables clear definition of operational and cost demands from vendors.

• These companies will engage in typically lower levels of outsourcing, and will keep most cost savings in-house rather than sharing them with the vendor.

Transform-Operate-Transfer

• Organizations employ vendors to transform a function and to run it for a short-term period.

• Transformations are often more easily achieved externally than internally; thus, the benefits outweigh short-term outsourcing costs.

• This model is relevant especially for companies in volatile/fast-moving industries, where rapid changes and adjustments are required.

Commodities Outsourcing

• Companies will pursue outsourcing of non-core, non-strategic, and non-differentiating functions (e.g., Web-hosting and mailroom services).

• Companies will outsource these types of functions to vendors that specialize in these areas. The vendors’ “economies of expertise” suggest the vendor will better manage and run these functions.

Risk Transfer (“Insurance”)

• Outsourcing functions, such as disaster recovery, enables organizations to spread the operational and financial risk for functions that they are less able to perform in-house, providing insurance-like protection.

Shifting Fixed Costs to Variable Costs

• In human and financial capital intensive areas, such as legal or infrastructure, vendors offer organizations economies of scale and flexibility, allowing the shift from fixed costs to variable costs.
Appendix: Literature Sentiment Index

**Approach**
- For the period January 1, 1999 through December 15, 2004, all articles with significant mention of outsourcing and published in the following six leading journals were read and rated: Business Week, The Economist, Forbes, Fortune, The Wall Street Journal, and The Washington Post (more than 570 items).
- Each article was rated on whether it was pro-outsourcing, anti-outsourcing, balanced, or informative-only.
- Results were tabulated and graphed.


**LexisNexis® Negative Phrase Search Results**

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**Approach**
- For the period January 1, 1999, through December 15, 2004, LexisNexis® was searched for instances of 13 stock phrases, indicating sentiment against outsourcing (e.g., “outsourcing failures,” “outsourcing controversy”).
- These findings were compiled and graphed.

Source: LexisNexis®
Appendix: Analysis of Problem Deals

Problem Deals Breakdown by Outsourcing Type

- Sample skewed towards BPO, possibly indicating either that BPO deals fail more often (they are a newer type of contract) or that the BPO failures are well-publicized

Source: Randomly Chosen 50 Problematic Outsourcing Deals from LexisNexis®, Factiva and Proquest

Problem Deals Breakdown by Deal Value

- Sample is dominated by problematic deals that are large in size (over $100M). While bigger deals may fail more often than smaller ones, it is more likely that larger failures tend to be publicized more often
- Estimations based on available public information for 24 of the 50 deals in the sample

Source: Randomly Chosen 50 Problematic Outsourcing Deals from LexisNexis®, Factiva and Proquest

Of 50 Problematic Outsourcing Deals Reported in the Media, 76 Percent Ended Up in Deal Termination or Litigation

- Most deals for which the timing is known, fail in the first year (11) or first five years (16). This is consistent with other research, such as Dun & Bradstreet (2002).
- Estimations based on available public information for 33 of the 50 deals in the sample.

Source: Randomly Chosen 50 Problematic Outsourcing Deals from LexisNexis®, Factiva and Proquest
Underperformance and Cost Overruns Are the Key Drivers of Outsourcing Problems

- Underperformance: 59%
- Cost Overruns: 15%
- Other: 6%
- Fraud: 4%
- Intellectual Property Issues: 8%
- Labor Standard Violations/Labor Unrest: 8%

Source: Randomly Chosen 50 Problematic Outsourcing Deals from LexisNexis®, Factiva and Proquest

Key Issues Underlying Underperformance*:

- Outsurcer Overexpectations: 45%
- Poor Management: 35%
- Lack of Skills/Expertise: 35%
- Technology Problems: 24%

*Given that failures have multiple related causes, the total number of causes may be greater than 100 percent
Source: Randomly Chosen 50 Problematic Outsourcing Deals from LexisNexis®, Factiva and Proquest

Key Issues Underlying Cost Overruns*:

- Hidden costs and “Teaser Rates”: 50%
- Demand Management: 25%
- Inflexibility of contracts: 13%
- Disagreement Over Cost Metrics Used: 13%

*Given that failures have multiple related causes, the total number of causes may be greater than 100 percent
Source: Randomly Chosen 50 Problematic Outsourcing Deals from LexisNexis®, Factiva and Proquest
Endnotes


3 Dun & Bradstreet Survey 2002.


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