The Real Outlay on Outsourcing

Karen E. Klein (March 21, 2005)

The cost savings of outsourcing have been ballyhooed for years. But it turns out lower cost often comes at a price: increased failure rates, loss of institutional knowledge, extra travel, less innovation -- not to mention cultural and security issues. So what's the real outlay on outsourcing, and what can be done to reduce it?

Although outsourcing typically delivers lower costs, recent studies have shown that about half of outsourcing contracts ultimately fail. Why? Often, management abdicates responsibility for an "out of sight, out of mind" outsourced project, fails to consider hidden costs such as travel, underestimates the importance of culture clash, or outsources a critical function that should be done in-house.

In order to ensure a successful outsource relationship, whether the work is going to a domestic firm or being shipped overseas, executives must carefully choose partners and establish meticulous management practices, say a handful of senior executives who have had mixed results with outsourcing. They must also know when to just say "No" to the short-term temptations of outsourcing for the long-term good of their organizations.

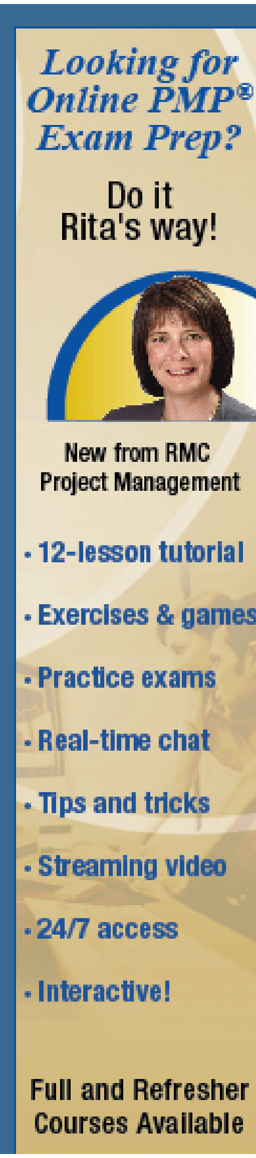
"Look at what makes your business special. Typically, it's the knowledge about your industry and your business niche," says Dion DeLoof, CEO of Anteo Group, a project-based information technology staffing and ROI consulting firm based in Atlanta and London. "Outsource the well-defined, straightforward tasks that don't involve a lot of architecture and creative thinking. But when it comes to your core competency, think hard about whether you want to send that outside."

David Buckley, CEO of ModTech, a national manufacturing and construction company based in Perris, Calif, says companies get tripped up when they try to outsource ideas, rather than specific jobs. "People have a general idea about things they want done and they run out and find an expert to do them. The problem is that your idea may not be the same as the expert's idea of the job," he says.

Due Diligence

When evaluating an outsourcing partner, Buckley goes through a checklist of "must-haves," including certifications, licenses, qualifications and related work experience. He also does background and reference checks.

Along with such general credentials, finding an outsourcer familiar with his industry was important to Shane Bouslough, vice president of information systems for Eureka Networks, a small firm that provides dial tone and Internet services to business customers in New York and Washington, D.C. Bouslough



was tasked with overhauling the company's order-flow software, a short-term, time-intensive project that he didn't have the resources to handle.

Early this year, he outsourced the project to an IT company based in India. "I had a short list of candidates. I vetted their financials, asked about employee retention and looked over their customer base. I wanted to make sure they had application domain knowledge and experience doing projects in telecomm because I knew that would be a big advantage for me," Bouslough said.

The interview process was also important. "They brought candidates to us and we conducted formal interviews over the telephone similar to what we would do if we were going to hire someone locally. In the end, what swayed me is that one of my employees knew the firm, had worked with them before and could give us a personal recommendation," he said.

Once a partner is selected, the work of setting up the outsource contract begins. Jim Leto, CEO of Robbins-Gioia, a $100 million program and project management consultancy in Alexandria, Va., says contract negotiations take from several days to several weeks to complete with his many government clients. "We come up with an enterprise program management plan that includes specific goals and performance metrics for measuring them. There are status meetings that take place weekly, monthly or bimonthly," Leto says.

Such regular status meetings are crucial, as is a cancellation clause. "If you outsource, you need to assume the worst is possible," DeLoof says. "How will you react and how will you bring the project back if it goes very badly?" A disaster recovery plan that details how you will fix a botched project, particularly if 80 percent of it is being done on the other side of the world, is also a must. "Do you still have people in-house who could pick up the ball, or have you let them go or watched them move on?" he asks. A detailed risk analysis done before the outsource contract is signed should address these questions.

Having a staff member individually responsible for the outsourced project is also important. "Put a short leash on at first, so your representative can give you continuous feedback on whether the outsourcer is meeting expectations," says Buckley. Performance metrics may include specific goals to be reached over time, such as producing so many units per day or completing a portion of the task by a certain date at a certain quality level. "You don't want to micromanage, because you want the vendor to be able to shine, but at the same time you want to make sure they're doing what you wanted, the way you wanted it done."

Culture Clash

Making sure that your company culture meshes with your outsourcer's company culture helps ensure a good outcome, particularly when you are outsourcing customer interaction.

Buckley says he learned this principle the hard way when he worked for a company some years ago that outsourced its collections as a way to save money. "We told them we expected them to make a dozen calls an hour and collect up to 80 percent of our outstanding receivables," he recalls. "But we didn't instruct them clearly on how to do that and we didn't put in a good process to monitor the calls. We found out later that the outsourcer was acting as a collections agency, not as our representative. They were rude and harsh to some of our best customers, who eventually started complaining about the treatment." By the time senior management realized what was happening, the outsourcer had destroyed so many relationships that the business went under.

That experience left him with a hard-and-fast personal rule: Never outsource any job or project that involves customer interaction. "It's crucial — your customers are too important to turn them over to someone outside your company," Buckley says. Other firms, of course, do outsource customer interactions, especially those involving routine technical support. But doing so is a risk, particularly if you are offshoring. "Some customers don't want to talk to people with foreign accents, or if they realize they're talking to someone overseas they don't feel like they are connecting with someone who can really answer their question or solve their problem," he says.

Cultural differences involve concrete things like time zone discrepancies and intangibles such as nationalistic or corporate mindset. DeLoof says many of his clients have sent IT projects to India, only to find out that hard-to-quantify attributes like innovation and creativity are lacking. "If you have to stereotype, which you do, you find that people there don't have the freedom to speak up or the entrepreneurial culture that rewards them if they tell the boss what they're really thinking. Here, we're taught to challenge and question authority, so an employee who tells the boss that some process doesn't make sense and should be changed gets promoted. But when you ask an offshore IT provider to come up with three or four ideas to shake up the product, you may get, 'What are you talking about?'"

On the other hand, some cultures may be perceived as overly aggressive compared to American society. Jim Etkin, CEO of MPBid.com, a Florida-based online booking service for meeting planners, has outsourced the site maintenance and updating to a Russian programming firm and likes the fact that his outsourcers work in a time zone eight hours ahead. "We can send in changes, they go to Russia, and the next morning they're done," Etkin said.

But when the site began experiencing some major glitches recently, the offshore programmers and Etkin's web server provider, based in the Midwest, "got into a hissy fit," with each side blaming the other for the errors. "When you speak with people from other countries, their English is a little different than ours. The Russians were more direct about something that we might say a little softer and the server felt like he was getting punched in the nose. Pretty soon, there was venom going back and forth via email and we were right in the middle," Etkin recalls.

Along with culture considerations, there are also security issues that come with outsourcing. While checking credentials and sending information securely is relatively easy, trusting your company secrets to an outsourcer with high employee turnover rates is not. Particularly in hot offshore markets, where salaries are rising and new outsourcers are cropping up, employee attrition is high. "In the U.S., we have strict controls on intellectual property rights and non-compete clauses, but if you're hiring overseas much of that goes out the window. Your competitor can outsource with a firm that works down the street from your outsourcer and advise them to hire the 10-person team that works on your projects," DeLoof said.

Sudden Loss of Vision

While you may be vulnerable to occasionally losing intelligence to your competitors, a more prevalent risk of outsourcing — onshore or offshore — involves the loss of institutional knowledge, including feedback from clients and customers, problem-solving capability, and the spontaneous collaboration that occurs when everyone working on a project is in the same building. "People get excited about email and video conferencing, but it's still tough when half the team is at another location," DeLoof notes. "There is tremendous value in collaboration that isn't measured when the initial cost-savings of outsourcing is presented," he says. "Even if a company can save 50 percent on its labor costs by going to an outsourcer, they're also potentially losing their visionaries. Suddenly, the vendor has taken all the feedback on the product but they can't evolve it, and the folks in-house don't have specialists close enough to the customers to do it either."

Expectations about ROI are often unrealistic because of these hidden costs. Any evaluation of cost-savings should include not just lower labor costs, but a detailed financial assessment, taking into consideration such things as contract setup and monitoring, time differences, travel and communications costs, loss of institutional information and reduced productivity due to language and culture differences.

In general, most outsourcing contracts promise to save your firm at least 15 percent up front. In some cases, outsourcing routine, low-cost tasks that free up your higher-cost, in-house employees to do more skilled jobs can save as much as 50 percent. Buckley says if an outsourcing arrangement doesn't save him 12 percent year after year, he won't bother with it.

Etkin outsourced his website after he established it three years ago. A full-time programmer would cost him $100 an hour, plus benefits, where outsourcing the same role cost $40 an hour. The outsourcing firm he chose had a large staff of programmers that could handle the occasional large jobs he threw at them. "If we had one programmer on staff who got sick and was out for a long time, or decided to move to another company, we'd be in big trouble. We could spend a month looking for a new staff member and then another couple of months to train that person and bring them up to speed. Meanwhile, our site wouldn't be updated," Etkin said.

But the advertised cost-savings is not always realized, said DeLoof. One of his current clients recently tried offshoring with a staff of 30 working overseas. They quickly found they needed to send four or five staffers there regularly to supervise but travel costs hadn't been figured into the equation, nor had a lower productivity rate. "He didn't realize that it would take 30 people there the same amount of time to do a job that 15 people could do in the U.S., so the total cost of the project didn't save him any money at all," DeLoof said. "They decided to take a totally different tack and open tech centers around the U.S. but in places like Savannah, Ga., where the salaries are 15 or 20 percent less than what they'd pay in Atlanta or Boston. Their labor cost is still more expensive than they were paying overseas, but the work is done so much faster that their delivery costs are extremely competitive."

In-Sourcing

What is emerging among the best practices for managing the outsource relationship is a model that might better be called "in-sourcing." It involves shared risk between the outsourcer and the project manager. Instead of just handing off a project, good managers are inviting outsourcers to send a representative or an entire team to work on site. That way, they can supervise the work personally and withhold invoices until agreed-upon metrics are met.

Bouslough's offshore partners sent a full-time employee to work at Eureka Networks, absorb the company culture and supervise his two counterparts back in India, one of whom devotes half-time to Eureka's software update. "We're getting the time of 2.5 programmers for what it would cost us to have one full-timer here," Bouslough said. "So far, I'm very satisfied."

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