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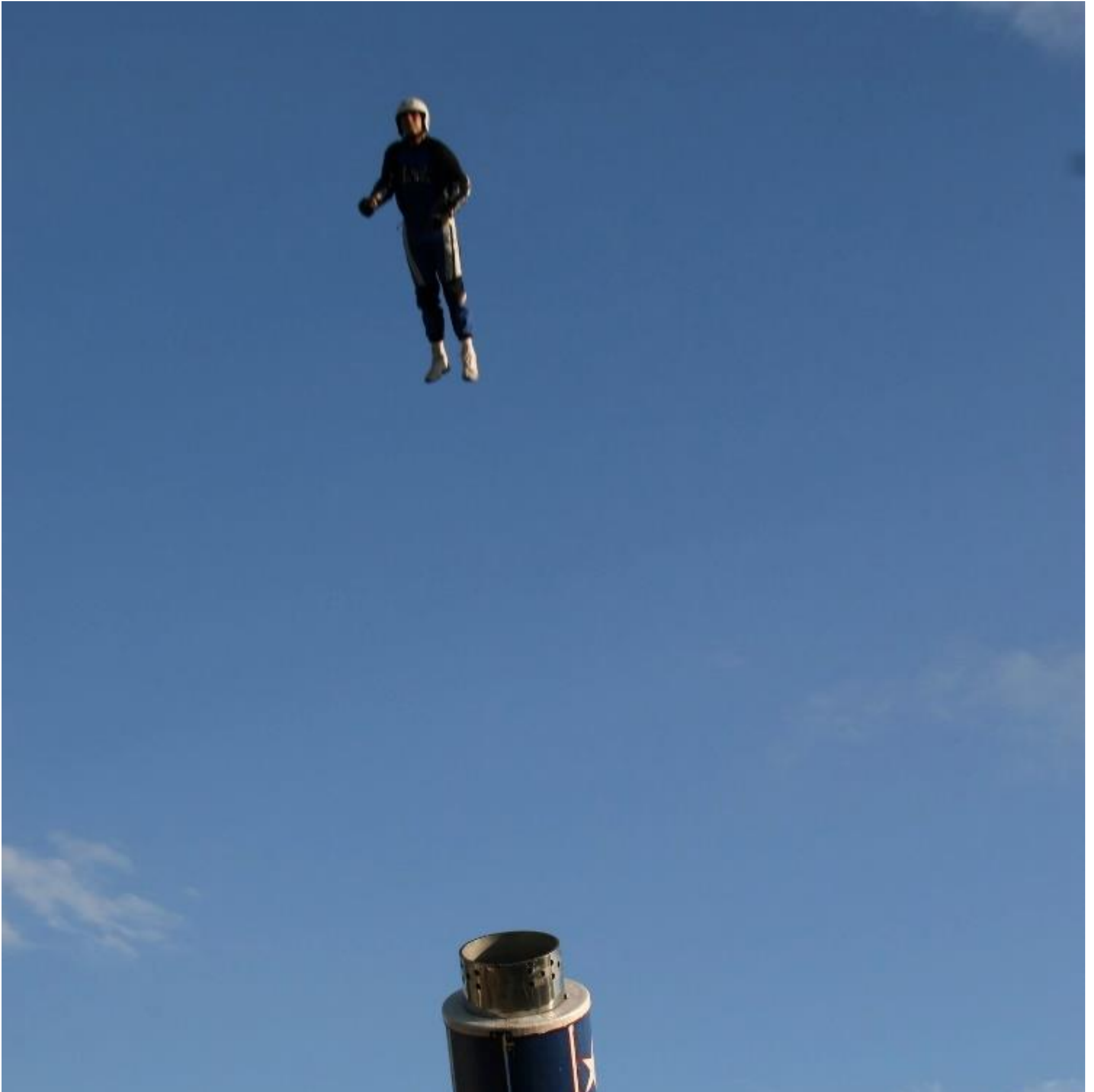
YOUR BEST OPTIONS IN MOTION



Outsource, Insource, Shared Services or Plan “D”?

The Question Every CEO & CFO Will Need to Answer

The image we selected for the cover of this paper is of a human cannon ball being shot out of a very large cannon. We think the image is a good analogy to what many CEOs have to do. To ensure the man being shot out lands at his designated target there has to be many variables to consider (gun powder, weight, velocity, wind resistance, and trajectory). Not properly considering all these components can have an unfavourable outcome for our human cannon ball.

At some point in every CEO and CFO's career the question will arise over what is the best path to adopt for a particular business process that is a cost item on the P&L. The options available are not as straight-forward as you might think. For instance many companies simply consider whether to keep a function in-house or outsource it to a third party. There are other options available to consider such as having a co-sourcing arrangement with a vendor or creating an internal shared services department (defined later on) or even carving out a business function and converting this into a business in its own right to sell services to other third parties on a commercial basis. Then of course there is the option of selling the business unit to a third party as an asset in exchange for a committed period of servicing.

These options are complicated and have a number of repercussions. Sometimes heading down one path may lead to poor business outcomes or perhaps it may solve a short-term problem but create a long-term issue in the business. Some paths may in fact produce a neutral result with little up-side and in some cases the wrong path can have negative and detrimental effects that may hamper business growth or worse make it difficult for the business to remain a going concern.

What Are My Options?

It's important to know your options, understand the positives and negatives of each and also the likely impact on your business from a short, medium, and longer-term basis.

Many simply don't understand the options thoroughly enough or the various permutations available with each option. The level of detail is beyond the scope of this paper but we will hopefully provide a summary to help capture the essence of each option and to encourage further investigation based on suitability.

The definitions for each option is outlined below:

Outsourcing:

Outsourcing of a business process is related to the delivery (or part delivery) of a business process by a third party *not* owned by the legal entity that requires the services.

Permutations to Outsourcing:

There are number of permutations to outsourcing to consider such as:

1. **Co-sourcing**: this is where part of the total service is delivered by the company in partnership with the third party provider

2. **Offshore, near-shore or domestic delivery**: This the option of where the service will be delivered from and is usually determined by such issues as labour arbitrage, supply of skilled workforce, and quality of service delivery

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3. **Fixed, variable or performance related costing:** Costing by third parties can be on a fixed time and material basis or it can be variable and linked to the completion of a particular process or it can be related to the performance of the provider and the work they perform. Often these pricing components are used in combination and are not exclusive to each other.

Insource:

A business process is considered to be insourced when the majority of the costs, usually 70% or more, of delivering the business service is paid to a department within the organisation and delivered by resources directly employed by the company.

Permutations to Insourcing:

1. **Extension of Services**: an insourced operation may extend its services to other departments acting as a pseudo "service provider". This extension is usually a means to gain cost efficiencies within a company.

2. **Partial use of outsourcing:** An insourced centre will often use third parties to achieve its business function. However, the value of the outsourcing used is usually no greater than 30% of the total cost and is considered of low strategic value.

Shared Services:

Shared services is when a company identifies a large number of duplication in its various divisions and decides to centralise some core functions and "share" resources to perform common functions such as recruitment and accounting. The company ultimately creates a legal entity with the primary focus of serving departments within the company as a service provider. The idea behind shared services is to reduce costs by removing duplicate resources and to make processes more efficient because the resources of the shared services develop greater expertise performing the same task multiple times. This creates specialisation and standardisation leading to efficiencies (theory of industrialisation) which can be capitalised on using the shared services model.

Permutations to Shared Services:

The key permutations to the shared services model are:

1. The company can recruit external vendors to become shareholders of the shared services entity instead of the company remaining as the sole shareholder. Often this takes the form of a joint venture between the two entities. The key reason behind bringing in external parties would be to introduce new expertise in the effective operation of the shared services model. Often companies understand the benefits of a shared services operation but will lack the necessary expertise to operate it like a service provider. Often the likely partner selected would have outsourcing experience as a provider.

2. The company may also seek a "double benefit" from the shared services by gaining some cost savings from the location where the shared services will operate from. So in addition to creating a shared services model the company may decide to relocate the services to a lower cost base so it can benefit from labour arbitrage. The options could be to take the service to a near-shore or offshore location where there are cost advantages.

"Plan D"

We call it plan "D" as this option is the fourth variety of options available to any CEO or CFO to consider before presenting to their board members. Plan "D" can take on a variety of

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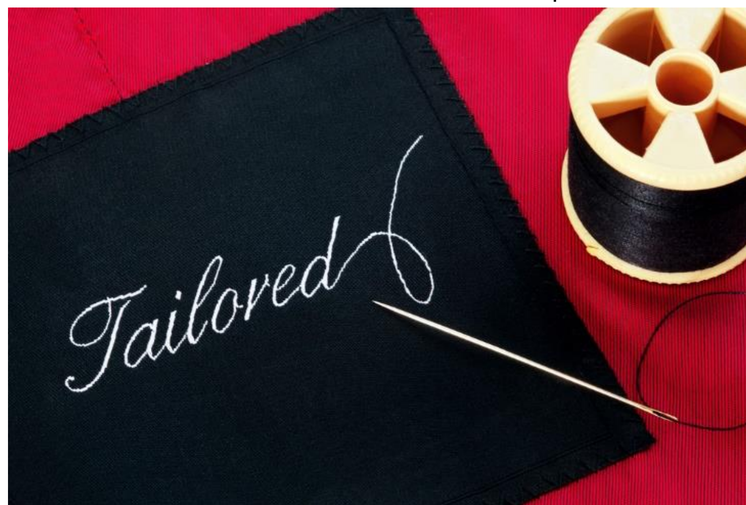
different shapes and sizes. The options are limited only by the imagination. There is of course the danger that the permutations of plan "D" are too exotic, complicated, and ultimately unlikely to achieve the required business outcome as a result. The fundamental rule in business that we adhere to as "one of the golden rules" is to always seek out a solution with as few moving parts as possible. The less complicated the better in our books.

Plan "D" does offer some commonly accepted and proven options that do in fact provide good alternatives for some companies to the three other options (outsourcing, insourcing or shared services) available. The most notable options available in this category are as follows:

1. **Creation of a commercial outsourcing company**: A company has a business process that it currently performs in-house and is fully funded by the company as a regular P&L cost item. The company realises the in-house operation is inefficient and not operating to world best practices. It reviews the various options and then decides it would like to either outsource the function or invest further in the department to raise it to the proper standards. The company seeks to have control and does not like the idea of increasing its costs further. The alternative is to create a new legal entity that is partnered with an outsourcing specialist to offer its services to the open marketplace. This will enable the company to fix its best practices issues and to offset the costs of the department and make a profit over time since the new entity will be a "for-profit" commercial entity. This model has proven to be highly successful for organisations like GE. This model has to be carefully thought and requires some key characteristics to make it a success. The key ones are as follows:



   a. The department to be converted into an outsourcing entity needs to be of a **sizeable nature to create the necessary revenues to make the new entity commercial viable.** For example, a company with a 500 seat call centre will have a better chance of creating a BPO company than a company with 50 seats.

   b. Bring in expertise. Attempting to establish an outsourcing company without the prior experience or knowledge is likely to lead to the entity failing. **It is a flawed assumption to think new customers will come to your new entity simply because of your reputation in the marketplace.**

   c. **Be prepared to make changes**. The introduction of this new outsourcing company will require changes to be made to the current operations. The new equity partner is likely to make changes in people, processes and technology. This is necessary if the new entity is going to make a profit without the need to pay an additional amount for the delivery of services. Usually the inefficiencies in the operation will provide the new entity with the immediate profit it requires to become commercially viable. Over time this cost should be directly reduced and indirectly offset by the profits and growing value of equity in the new outsourcing company.

2. **Equity Carve Out.** This is defined when a company decides to "spin-off" or sell an existing department to a third party. This

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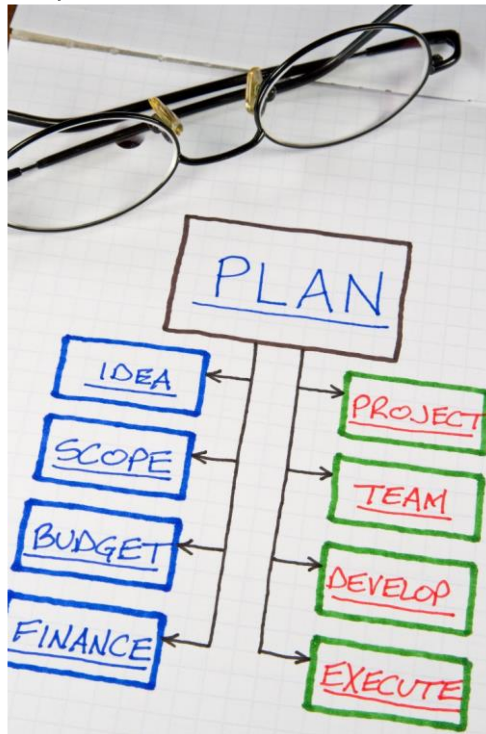
third party can be a single company or it can be offered to the public via an IPO. The latter is usually only possible if the new subsidiary company to be "carved out" is worthy of public investment interest. **Often this option is considered to raise capital for other purposes.** The classic 2001 carve out case study was Philip Morris and their IPO of their partial holding in their subsidiary Kraft Foods.

The IPO path is the least common one taken. The option more companies are adopting comes in the form of direct sale of assets to a single organisation. In the case of business services the asset needs to be protected from erosion is value so the deal is made with a fixed term contract that the company will give the purchaser of the asset guaranteed services for a significant term, usually 10 years is the minimum, to ensure revenues are delivered to the purchaser at the expected rates. The purchaser benefits because their value as a company increases in proportion to the revenues and profits it can generate. An example is evident in the sale of the back-office functions of Goldman Sachs to State Street Corporation for $550m in 2009.



3. **Strategic Acquisition**. A company may be facing market pressure due to changes in technology or its business model. Dwindling revenues may signal a significant threat to the survival of the company. The company may have significant employees and wants to remain significant in size. The options to consider may involve outsourcing and downsizing but an alternative approach could be a strategic acquisition to enter a new market or industry sector altogether. **There is often a key strategic shift required in order to maintain sustainability.** This is often a complicated and difficult option but can ultimately lead to future survival. One of the leading examples of this option is when Xerox decided to enter the BPO industry by acquiring ACS for $6.4B in 2009. This strategic shift would enable the company to leverage some of its asset and avoid diminishing in value if it had maintained its existing business offering.

Dimensions to Consider

The dimensions for consideration will vary with every company. However, there are common areas of consideration to help you determine which path you should take. The common and most important ones to consider are as follows:

1. How well do the various options fit into your overall strategy and business objectives?

2. What is the primary key driver for your decision-making? Is it to save money or make money or is it a combination of both? One option must outweigh the other. Giving equal weighting to this question will likely lead to a flawed outcome.

3. What investment is required and does this investment fit into the shareholder risk profile?

4. What is the worst case scenario? Don't base your decision-making on best case scenario. It will only lead to embarrassment in the board room.

5. What is the most likely pay-back for this investment?

6. What are the key risks and are they within acceptable levels of what the board is likely to tolerate?

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7. Does the effort warrant the likely pay-back?

8. Do you have the resources and bandwidth to execute? If you intend to use mostly internal resources this could lead to a major shift in focus from your core business. Working with a partner can ensure you are able to execute without loss of focus on your core business.

9. What is your exit strategy? Not having an exit strategy and knowing the triggers for exit can lead to poor long-term outcomes.

10. What are the financial implications of your arrangement? Include in your analysis such areas as: equity arrangements, corporate governance model, stock ownership model, debt/equity financing, taxation, and foreign currency risk.

Where to Next?

This paper was designed to help C-level executives get an understanding of the options that are available to them. Many executives don't fully explore the variety of options and their permutations. The norm is to discuss business processing in terms of either insourcing or outsourcing. Very little consideration or thought is given to the other options available such as shared services or as what we have termed "plan D". Often the latter two options can yield far greater business benefits. Options that can successfully convert cost centres into profit generating centres or assets are to be prioritised over those that generate marginal savings.

Proper development of a strategy and business case generally requires external consultancy. We encourage executives to explore the various options and to debate the pros and cons of each option prior to deciding on which path to head.

Kinetic BPO is committed to helping companies and government make the right decisions regarding their business process operations. We would be happy to discuss with you how we may be able to assist.

If you would like to know more about how we can help you improve your customer experiences then contact us at:

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