

Outsourcing – into 2010 and beyond

Outsourcing is more popular than ever, but success is by no means guaranteed. *Calum Murray and Paul O'Hare* explain how to avoid the pitfalls.

Market analyses indicate we'll see greater use of outsourcing in 2010 than ever, but individual deal values will continue to fall, customers will commit to suppliers for shorter periods and existing longer term deals will be restructured. Customers will also increasingly multi-source, offshore services markets (China, India, South Africa, etc) will grow faster than other service provision centres, growth of business process outsourcing and HR outsourcing will outstrip other sectors and business transformation outsourcing (BTO) will become increasingly common.

This evolution of global outsourcing markets will not fundamentally reshape how projects are negotiated and documented, but legal and commercial teams will need to finesse existing contractual models to accommodate new demands if projects are to be successful. Below, we suggest six golden rules for the next 12 months.

Redefining deal structures

Outsourced services deals are getting shorter and cheaper. Competition has driven down the cost of many services, particularly where they can be offshored. For certain services (e.g. IT), the underlying production costs of non-people resources have also fallen dramatically in recent years, meaning customers don't need long-term deals to balance affordability with supplier return on massive front-end investment. The increasing trend to multi-source is also reducing deal values, with previous 'one stop shop' services divided among several suppliers.

Rule 1 – Pay attention: As deals get smaller, it is tempting to give them less strategic attention, but this should be resisted. Simply because it is now cheaper to outsource does not mean it is less risky. If the service falls over the customer may have wasted less money, but the impact on its business will be no less significant.

Negotiators still need to be realistic about risk apportionment. A supplier will usually earn less from a lower value deal and the customer should therefore expect lower aggregate financial risk assumption. But contracting for risk makes sense to avoid protracted, expensive disputes that may end in litigation.

Rule 2 – Multi-source for quality: Multi-sourcing can potentially significantly reduce the impact of failure because only a part of a service has been outsourced to each supplier. But in practice, multi-sourcing creates new risks, through integration and inter-reliance, and the possibility that one supplier may cause others to fail. Worse still, no supplier may be responsible for failure at all, if none has assumed the integration risks. Therefore, multi-sourcing requires greater project governance, whether by the customer or outsourced to one supplier assuming responsibility for service delivery.

Rule 3 – Contract for flexibility and exit: While it may be inevitable that requirements change from project inception to implementation, if customers wish to avoid the often high costs of restructuring, greater pre-signature consideration must be given to contract flexibility and exit management. If contracts permit flexibility they're less likely to require restructuring.

While there will probably be some additional premium for contract flexibility it is likely to pay off, particularly for longer term-deals. If the changes required are outside the supplier's scope of competence, or cannot be provided on attractive terms for both parties, mechanisms must be in place to permit a swift and painless insourcing or supplier replacement. Negotiating exit is less difficult in advance than when it's needed.

Offshoring

Indian service providers have established themselves as global IT and BPO services providers. However, some commentators predict India may struggle to keep its high share of the global BPO market, as costs pressures, poor infrastructure and lack of available talent cause customers to look elsewhere.

Rule 4 – Be selective: The most important commercial rule for offshoring is to only outsource services that cannot be adversely affected by location. In 2010, a further refinement of offshore services locations is likely, with destinations such as the Philippines and South Africa increasingly taking the lead for customer-facing services, and India and China undertaking more programming and back office processing.

Rule 5 – Take advice: Having identified the most commercially viable location, do not underestimate potential legal and accountancy issues, and take local advice. It is vital to understand local tax regimes, IP laws, corporate and regulatory requirements, and for regulated businesses any requirements imposed by home state regulators. These factors can significantly impact the viability of offshored deals, so projects need to be structured appropriately.

Remember to account for local environmental issues. Many potential offshoring locations suffer more frequently from environmental disasters than European states. Business continuity provision is a must, and needs to be properly interfaced with contractual release mechanisms.

Rule 6 – Appropriately measure performance: For BPO and BTO, identify the strategic project objectives and how best to measure their realisation and consider appropriate benefit-sharing to map onto each party's investment into the project. Being predominantly output-driven, BPO and BTO projects tend towards partnership rather than supplier-customer relationships, and performance measurement and payment triggers need to be devised accordingly.

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