

IT outsourcing – the high road or the low road?

Case study and success factors

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Executive summary

Developments in the marketplace and technological advances are driving the optimization of value chains. In the process, CIOs everywhere are asking themselves the same question: Would our company benefit by outsourcing IT activities? Experience shows that it is by no means easy to find the right answer. The point of departure is to identify those aspects of IT that can be largely standardized and for which outsourcing makes strategic sense. Once this has been done, companies must carefully consider how best to manage their relationship with the external service provider.

In many existing outsourcing constellations, customer companies are looking for ways to adjust suboptimal contractual arrangements and get the whole undertaking back on track.

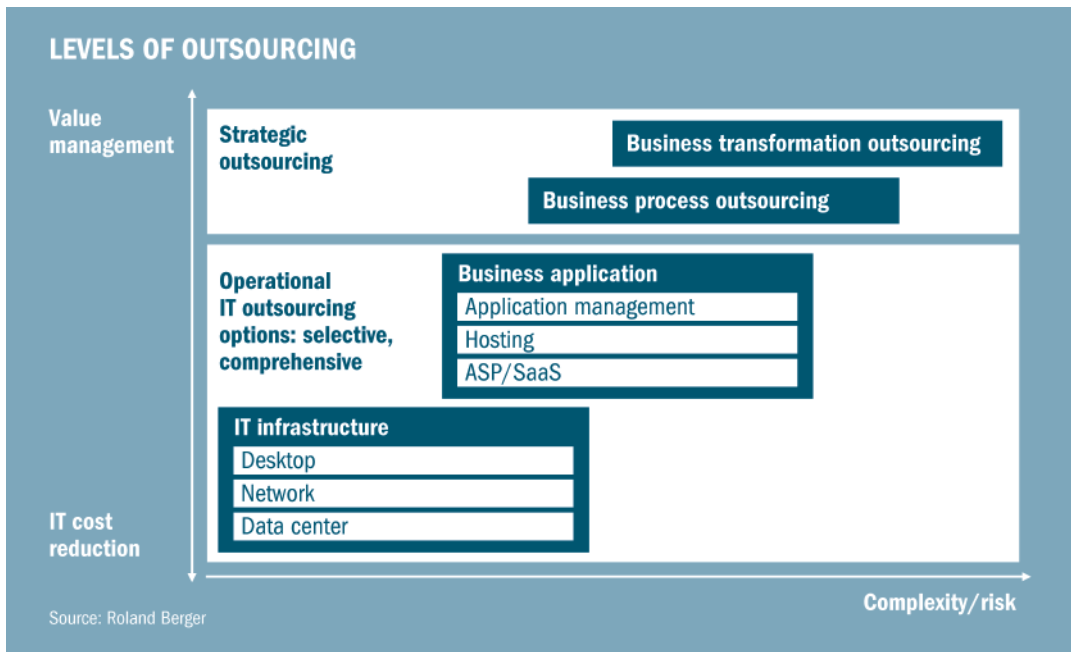
One thing has become abundantly clear: IT outsourcing is not necessarily the high road that leads inevitably to lower IT costs, greater cost transparency or more flexible services. We have accompanied successful outsourcing projects and been called on to salvage less than successful outsourcing projects. Drawing on this experience, we have identified specific ground rules and success factors that can help ensure that every project is designed – and implemented – successfully.

One example is the need to accurately analyze the total cost of ownership if genuine cost transparency is to be achieved. Another is the need to define in detail exactly what service items and packages are to be outsourced. To keep migration costs within reasonable limits, it is vital to plan the changeover carefully and to involve all relevant departments in this process. Appropriate personnel and change management programs must also be initialized. In addition, the degree to which services can be standardized will largely determine the extent to which costs can be cut.

In light of these ground rules and success factors, we have devised two alternative models that serve as valuable guidelines for the implementation of IT outsourcing projects.

IT outsourcing – What exactly does it involve?

IT activities can be outsourced in different ways. Distinctions can be based on both the extent of outsourcing and the degree of complexity. If a company is to sensibly evaluate the options available to it, it must first gain a clear understanding of the various levels of outsourcing and the implications of each. The traditional model, for example, farms out IT infrastructure and focuses primarily on cutting IT costs. Compared to the other alternatives, this model is less complex and is exposed to fairly manageable risks. At the other end of the scale, the outsourcing of entire business processes is an extremely complex issue that demands very careful value management.



Goals pursued by customer companies

Whichever level of outsourcing companies choose, they all hope to achieve similar goals by going ahead with such projects.

The foremost aim for every company is to reduce IT expenditure. In addition, recourse to a specialized IT service provider is expected to deliver a better quality of service and more efficient use of IT resources.

On the basis of contractual commitments, transparent pricing models and agreed service levels, outsourcing companies also expect IT costs to become more transparent and therefore easier to plan. A further important factor is that it must be relatively easy to scale up capacity, i.e. to buy extra capacity from the IT service provider to respond flexibly to shifts in demand.

Using outsourced IT services also gives companies the (usually long overdue) opportunity to standardize their infrastructure and/or harmonize applications and processes. After all, the existing landscape must be inventoried precisely before outsourcing can begin. Moreover, target IT architectures and processes can be chosen that align specifically with the company's business strategy. It is, of course, also in the interests of the outsourcing service provider too to standardize services as far as possible, as this is one of the main ways to exploit economies of scale.

TYPICAL GOALS IN IT OUTSOURCING PROJECTS AND THEIR IMPORTANCE TO THE CUSTOMER COMPANY

Typical goals in IT outsourcing projects	Importance
Reduce IT costs	
Improve quality and efficiency	
Increase transparency/make IT costs easier to plan	
Respond more flexibly to varying demand for capacity	
Standardize the IT landscape	
Align IT strategy with business strategy	
Concentrate on core business	
Gain access to expertise and new technologies	
Transform cost of capital/fixed costs into expenses	

Source: Roland Berger

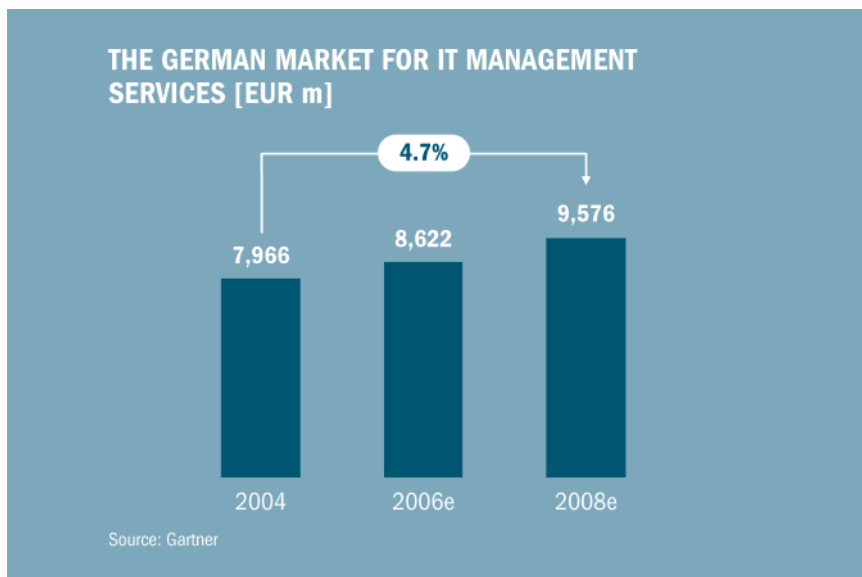
Goals pursued by the service provider

At the same time, the outsourcing company will naturally only be able to realize these goals if the given business case also makes economic sense for the service provider.

The latter will enjoy profitable growth only if the services it provides to various companies enable it to exploit economies of scale and benefit from synergies as its knowledge and expertise increase. From the total cost perspective, the service provider should therefore be below what it would cost for the customer company to handle the same services internally. In return for the business risks it assumes and the service levels that it contractually commits to deliver, the service provider expects customers to sign long-term agreements and pay a suitable risk premium – its profit margin, effectively.

IT outsourcing – Market development and current trends

For all the positive and negative reports circulated in the past, IT outsourcing remains an issue that is as topical as it is important. Annual market growth rates confirm this fact. In Germany alone, the market for outsourced IT services is expanding at a cumulative annual rate of around 4.7%.

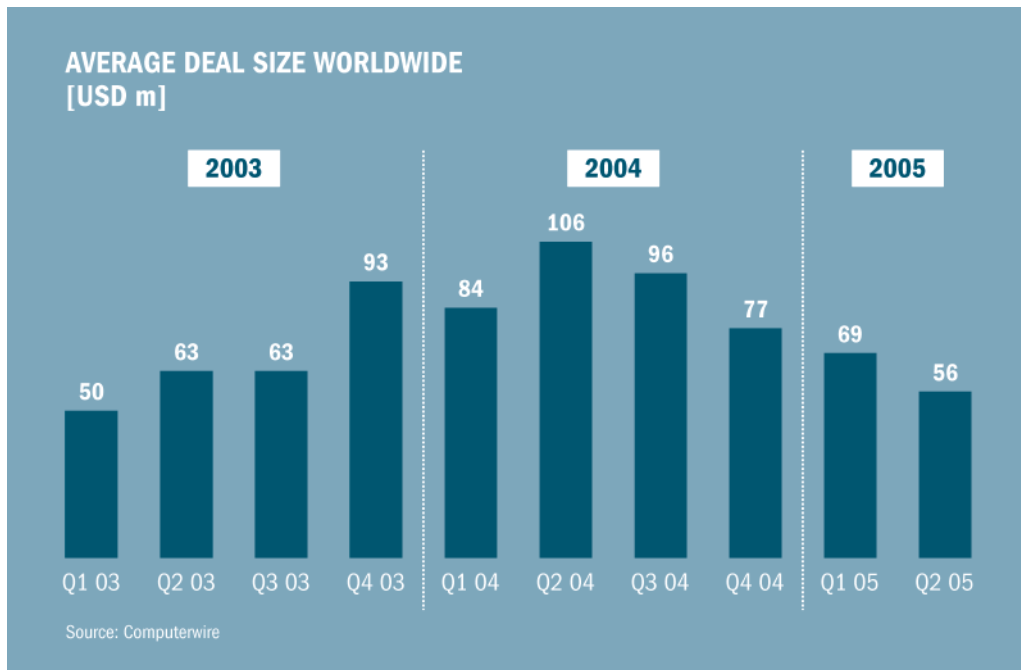


The majority of projects still involve the outsourcing of IT infrastructure, with a strong focus on help desk services, servers and wide area networks (WANs). The second most important category is the outsourcing of applications – especially enterprise resource planning (ERP) applications. Business process outsourcing (BPO) continues to play a comparatively minor role. Where this model is used, the primary focus is usually on HR, finance and the outsourcing of entire call centers. Even the German BPO market is still expected to grow by 3.75%.

The ten largest IT service providers in Germany, headed by the big full-service players T-Systems, IBM and Siemens Business Services (SBS), earned around 40% of their total revenues from outsourcing and project business

in 2005. The remainder of the market is occupied by a variety of providers and is thus heavily fragmented. Increasing M&A activities nevertheless point to further market consolidation. Gedas was snapped up by T-Systems in 2005, for example, as was RAG Informatik by SBS in 2004 and Triaton by Hewlett-Packard in the same year. Nor is it mere coincidence that these takeovers concerned captive IT providers. Through these acquisitions, the full-service heavyweights are seeking to gain access to customers who are becoming ever more choosy about what they outsource to whom.

The trend away from comprehensive outsourcing and toward selective outsourcing is likewise reflected in the evolution of contract volumes. In 2004 and 2005, average contract volumes dropped worldwide to some USD 56 million. True, there are still some mega-deals worth more than a billion dollars apiece. Precisely 21 such deals were concluded in Western Europe and 14 in North America from 2003 through 2005. In the same period, however, the average term of IT outsourcing contracts shrank from 6.2 to 5.3 years. One example of these increasingly rare mega-deals is the USD 1.7 billion contract that Kraft Foods signed with Electronic Data Systems (EDS). Under the terms of the agreement, Kraft Foods outsourced its global IT infrastructure (data centers, hosting, telecommunications and support) to EDS for seven years starting in 2006.

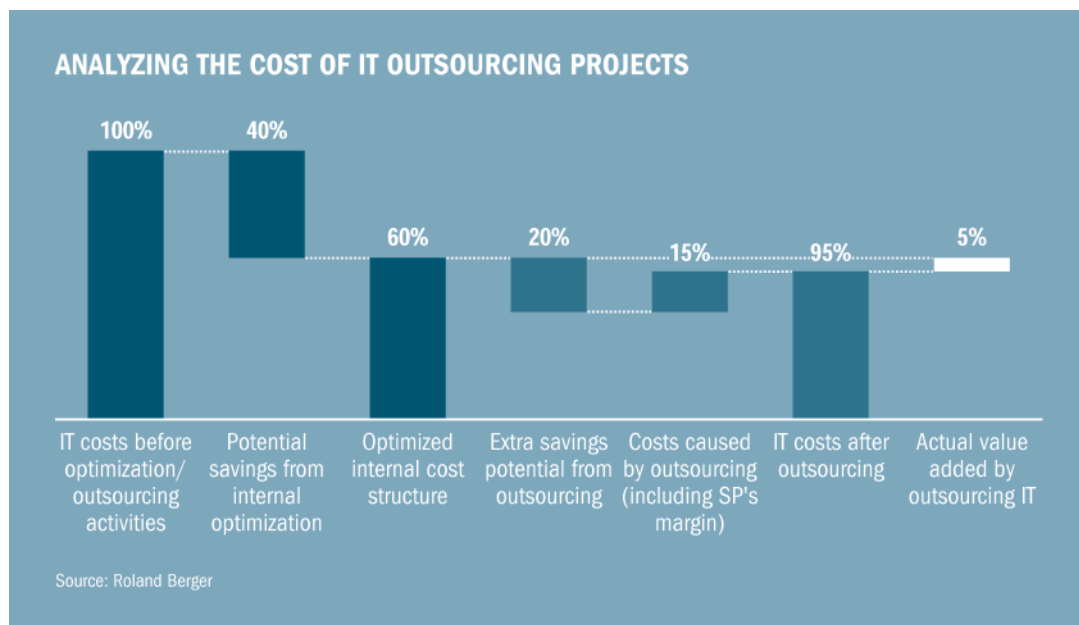


With corporate IT budgets generally back on the rise, these figures suggest that more and more companies want to buy IT services on a flexible basis. Accordingly, IT service providers are increasingly offering solutions instead of product-based models.

Pitfalls and lessons to be learned

One reason for the transition from comprehensive to selective outsourcing – i.e. to more flexible solutions – is that bad experience of outsourcing has caused many companies to become much more cautious. In 2002, Deutsche Bank placed its continental European data centers in the hands of IBM, signing a ten-year contract worth EUR 2.5 billion. Projected savings failed to materialize, however. A year later, DaimlerChrysler commissioned Hewlett-Packard to procure and operate all its desktop systems, laptops and network components in a five-year deal worth half a billion euros. After a sobering pilot phase, the German auto giant went running for the exit.

Whether customers outsource the running of an entire data center or only the management of certain applications, one often hears the same complaint: Too little value is added – or the savings realized are not enough. In many cases, the targets set could have been met at lower cost and with less risk by internal optimization drives.



This frequently happens because companies fail to assess the potential for adding value correctly in advance. Such analysis must always take account of the potential for optimizing services in house – not to mention the extra costs (e.g. transaction and migration costs) generated by outsourcing. Furthermore, not even an external service provider will be able to correct suboptimal internal processes if these are simply farmed out "as is". In our example of a company in the finance industry (see figure above), outsourcing the IT infrastructure realistically promised to cut costs by a mere 5%.

Failed IT outsourcing agreements can also result in substandard quality, defective implementation of complex applications and non-compliance with service level agreements, for example.

There are a number of reasons why projects go off course in this way. In some cases, the customer company does not have a clear understanding of its own internal IT costs when it signs the deal. Volumes are sketched only vaguely without referring to benchmarks for the various cost items. On the issue of contract design, many companies take too little trouble to compare contracts with those of alternative providers. Nor are service levels defined in sufficient detail. The procedure for transferring assets to the service provider is often equally nebulous, as are the rules by which the external company is to be managed and monitored. The same is frequently true of general communication between the contractual parties.

Seven success factors – What really matters when outsourcing IT

Our experience to date and our knowledge of common pitfalls have led us to identify seven key success factors for IT outsourcing projects:

1) Closely examine the total cost of ownership

The IT costs at issue must be identified precisely and exhaustively. This means clearly itemizing all costs. In addition to the cost of buying hardware and software, money spent on maintenance, human resources, ancillary equipment, security and peripheral technology must also be factored into the equation.

2) Define service items/packages and plan migration in detail

The customer must accurately specify the quantitative and qualitative requirements for outsourced services. The migration phase too must be planned in great detail. Since this process requires in-depth knowledge, a variety of departments will need to be involved. At the same time, it is important to ensure that everyone shares the same understanding of the purpose and parameters of the contract.

3) Standardize wherever possible

The more applications (and other aspects) can be standardized, the more it will be possible to reduce costs and comply with demanding service levels. If a disparate application landscape is merely farmed out to the service provider as is, the need for complex migration can quickly negate any potential savings.

4) Stake out a clearly defined business case

The business case must be clearly defined for both parties. The requested services, applicable standards, the objectives of the process and the target costs must be spelled out for the entire contractual term.

5) Monitor compliance with service level agreements

The best way to ensure compliance with service level agreements is to measure fulfillment on the basis of specific key performance indicators (KPIs) to which rewards and penalties are attached. The reporting process should also be detailed in the contract.

6) Manage personnel issues proactively

Issues such as the transfer of employees and organizational change management require special expertise. The appropriate specialists should therefore be called in at an early stage to map out robust, workable strategies and models.

7) Establish a system of ongoing strategic monitoring and control

The customer company must proactively manage the service provider. Communication processes must be aligned with the complexity of the services to be provided. The prices on which the contract is based should be benchmarked at regular intervals and also adapted as a function of service level compliance.

Case study – IT outsourcing at a logistics company

An Engagement Director at a large IT service provider company, uses a real-world case study to outline the pitfalls and success factors for IT outsourcing projects

Point of departure: A leading logistics group (with annual revenues of over EUR 10 billion) entrusted all its data center operations, computing, desktop and network services and responsibility for application management. The contractual term was set at seven years, the first year being defined as the migration phase. The underlying pricing model will be benchmarked on a regular basis and will be influenced by compliance with the agreed service level.

Customer's motivation for outsourcing: The customer's initial objective was to shift assets off its balance sheet, thereby transforming fixed costs into variable costs. In a further (subsequent) phase, reduced complexity and greater transparency was to shave 15% off IT costs. Existing applications were to be migrated to standardized services. ITIL-based service processes were to be introduced.

Outcomes: To date, the number of data centers has been reduced from five to three. The number of network ports has been cut from around 100,000 to 50,000 and the number of desktops from 70,000 to 45,000 (largely in line with adjustments in the headcount). Reducing the 300 or so applications proved a difficult challenge in the early phases. When the flat charge was switched to an application-based fee, the number was cut by about a third.

Lessons learned: When this IT outsourcing deal was put into practice, three main problems generated added costs and therefore diminished potential savings:

The complexity involved in migrating some applications to the new platforms was underestimated. One main reason is that the customer continued to develop these applications in parallel.

The use of non-standard desktop applications that interfered with each other caused delays in the migration phase and inflated the cost of migration. Additional standardization work and extra tests were needed to remedy runtime problems.

Due to these delays, outsourced IT services went into operation before the migration phase was completed. As a result, we were unable to comply with agreed service levels in the startup phase.

We can thus learn the following lessons from this project: Careful planning of the migration phase is vital to successful implementation of an outsourcing project. The best way to avoid underestimating complexities is, for example, to involve all of the customer's relevant departments in the contractual design process. In addition, the degree of standardization is critical if defined targets are to be met, as this is the most powerful lever with which to realize savings. Where a suitable level of standardization is reached, certain services can be "mass-produced" and therefore offshored to countries with low labor costs.

Practical roadmaps – Useful guidelines for implementing outsourcing projects

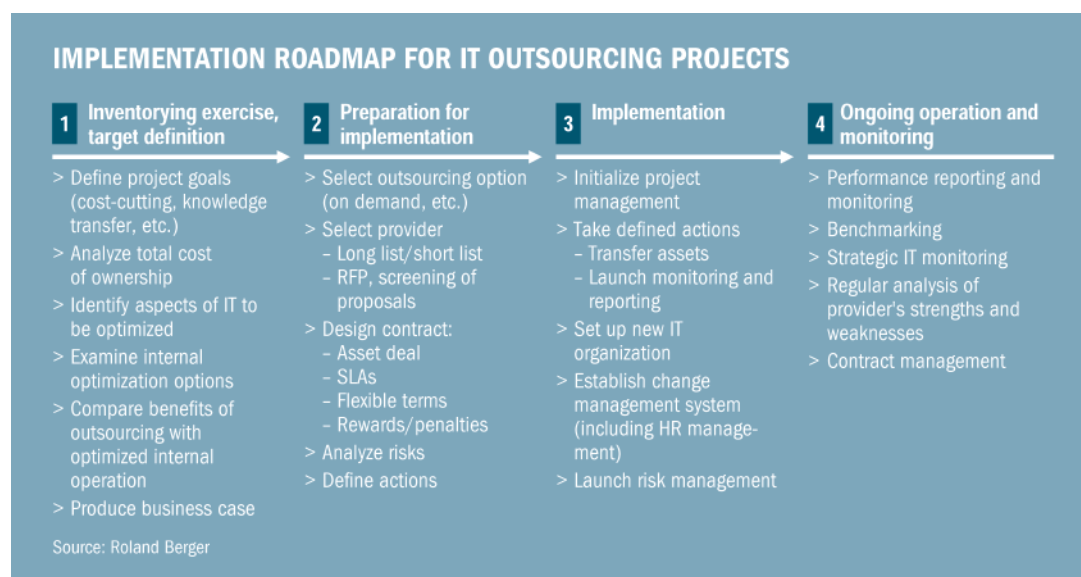
The companies we deal with either want to go ahead with an outsourcing deal or are trying to optimize existing agreements. In either case, standard implementation roadmaps can be drawn up on the basis of specific success factors.

1. Preparing and realizing IT outsourcing projects

The key questions that a company must answer in the preparatory phase are:

- > What is to be outsourced and why?
- > What is the optimal sourcing model?
- > Who is the best partner?
- > What issues must be covered by the contract?
- > How is the project to be managed and by whom?
- > Who has to do what and by when?
- > How are we going to monitor target compliance?

The roadmap for answering these questions breaks down into four steps, from clarification of the aims of the deal to ongoing management/monitoring and service delivery.



Step 1: Inventory the as-is situation

The first step is to identify those aspects of IT that need to be optimized in line with the company's stated aims. Once the total cost of ownership has been analyzed and the potential for internal optimization examined in detail, the benefits of outsourcing must be validated in a solid business case.

Step 2: Prepare for implementation

Optimal terms and conditions must be worked out before an outsourcing agreement is signed. It is particularly important to identify the right strategic outsourcing variant and the right outsourcing partner in light of the findings of exhaustive risk analysis. More general aspects of the contract must likewise be designed with great care, however. These include the terms of the asset transfer, service level agreements, flexible options to scale the volume/scope of services, and rewards and penalties.

Step 3: Proceed with implementation

During implementation, it is important to manage the outsourcing project proactively. Depending on the scope of services to be outsourced, IT operations must be reorganized and processes defined. It is also necessary to assign responsibility for managing and monitoring the service provider during ongoing operation. A package of change and personnel management activities is usually also needed to accompany implementation.

Step 4: Monitor the IT service provider's activities

Service delivery must be monitored on a permanent basis as part of activities to manage the service provider. Accordingly, the customer company is well advised to pay careful attention to this phase too. Above all, performance reporting, benchmarking, regular analyses of the service provider's strengths and weaknesses and active contract management are essential if effective control is to be exercised.

2. Optimizing existing deals

Where a customer is not satisfied with the services provided by an external supplier, the existing project clearly needs to be optimized. In such situations, the following pivotal questions must be answered:

- > What exactly is not working as it should right now, and what are the reasons?
- > What room do we have to maneuver within the terms of the existing contract with the external service provider?
- > Should we renegotiate the contract or terminate it?

When translated into a roadmap, these questions can again be answered in a four-step process:



Step 1: Inventory the as-is situation

The first step is to assess the importance of the outsourcing relationship to the strategy of the customer company. All problems must be recorded systematically, comparing target compliance with actual compliance (or non-compliance) in each case. Only then can the precise causes of each problem be analyzed in detail and the potential for improvement identified. Contractual loopholes and room to maneuver must be identified. The scope and definition of outsourced services may need to be revised. Ultimately, the business case must be adjusted in light of new targets and specifications.

Step 2: Evaluate and select options

Step two involves evaluating the options available and then choosing between them. It may be possible to renegotiate and amend the existing contract. Having analyzed and benchmarked the terms offered by other

providers, however, it may also be necessary to switch providers or insource IT services. In either case, the strategic implications and the cost of reintegration must be examined closely.

Step 3: Prepare for implementation

Preparations to implement the most profitable option are made in step three. If the contract is to be renegotiated, existing loopholes must be closed and both the reporting process and the contract management process will need to be overhauled. If the customer decides to switch to a different provider, it must terminate the outsourcing contract, possibly issue a fresh request for proposals and then engage in negotiations for a new agreement. The existing contract must also be terminated if the company decides to insource services again. In the latter case, a catalog of reintegration activities must be drawn up that accommodates the need to readapt the internal IT organization.

Step 4: Proceed with implementation

During the final phase – actual implementation – the course of action planned and prepared in the previous steps is put into practice. Each individual action is realized with due consideration for the relevant risks. Changes in the IT organization must be managed proactively and compliance with targets monitored consistently.

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