OFFSHORE OUTSOURCING: GETTING IT RIGHT THE FIRST TIME

© Pradeep Anand, President, Seeta Resources, www.seeta.com
pradeep@seeta.com, +1 281 265 9301

INTRODUCTION

Offshore outsourcing of services has caught the imagination of corporate boardrooms. Several Fortune 100 firms in North America, Northern Europe, and Japan have significant offshore outsourcing initiatives in place, reaping their benefits ahead of their competitors. The rush towards offshore outsourcing has turned into a stampede, fueled by access to lower-cost, high-quality labor, enabled by communications and other technologies.

The oil and gas industry is a "price taker", not a "price dictator". Consequently, the industry constantly looks for best-cost business models, and offshore outsourcing provides another opportunity to create best-cost enterprises in the industry.

However, before you join this stampede, you should recognize that successful execution has several minefields, pitfalls and hidden costs. This article walks you through the offshore outsourcing process, to reduce the likelihood of running into these expensive minefields. The process is summarized in a flowchart in the Appendix.

THE DRIVERS

The drivers and the scenario are almost identical in every situation- a firm's senior management team pores over financial statements, and after endless discussions and sleepless nights, recognizes that everything possible to improve profitability has been done. However, something has to give. Competition is putting immense pressure on market prices for their products, and there are just not enough margins to continue in the current mode.

So, where do they turn? Most will try to see if their current business model, shorn of excess fat, will work. Months go by, and morale droops as people are let go to reduce costs. However, these measures do not deliver the expected benefits, because competition is doing the same thing- reducing headcount.

After losing precious time in whittling away at the organization, the senior team pays big bucks to a blue chip consulting firm to parrot what was obvious to this team from the start:

1. Your business model does not work- competitive and pricing pressures are too high, margins have disappeared, you have an aging, expensive workforce, and you are bleeding cash.
2. You have to revisit your customers, competition, business climate, and figure out industry trends and discontinuities; pick ones that can put a strong wind in your sails and deliver better value propositions to your customers.
3. Once you have taken these analytical steps, you need to develop a more appropriate, profitable business model, and implement and execute it.

Leadership of some firms has sequentially gone through these steps. Others have intuitively jumped to step three. However, both groups have consistently reached a simple conclusion - we need to outsource activities that are not core to our business. Bottom line- it is a battle of competitive business designs that delivers value growth[1] and outsourcing is a significant contributor to improving your firm's Return on Capital Expenditures (ROCE).

As normal routine good business practice, the oil and gas industry discovered, perhaps about a century ago, the need to focus on "core competencies" and to shed non-core ones. The growth of the Oilfield Service Company industry is testament to this fundamental business insight that oil companies have always possessed and, more important, implemented.

For about a hundred years, the industry has quietly transferred activities to more efficient and effective business entities to create best-cost enterprises, thus delivering higher shareholder value. Unfortunately, these precepts and concepts of practice were not captured and 'branded' in management journals. The irony is that when articles on 'core competencies' began to appear in management journals, the industry looked upon these as if these were new concepts, and began adopting it with renewed vigor- outsourcing non-core or 'shared' activities, especially those related to Information Technologies (IT).

That was more than a decade ago. Many service firms especially in the IT industry benefited from this outsourcing trend. However, they were not the only beneficiaries. The combination- focusing on core competencies and outsourcing the rest- helped create various supply chains in manufacturing, accounting, oilfield service companies, and other services. This in turn created new challenges in managing vendors, information, and communications, and generated new business models that amply rewarded the swift footed. The compelling benefits of outsourcing far outstripped inefficient and ineffective execution of these practices.

However, as outsourcing proliferated across competitive landscapes, the competitive edge they provided early adopters began to diminish, and their competitive effectiveness was blunted. Many of these have promptly moved from the question "Should we outsource or not?" to "How do we improve the effectiveness of outsourcing?" While many industries and companies pondered over the first question, on their road to extinction, many have leapfrogged to utilizing Internet and telecommunications technologies, and the availability of a global work force, to accomplish their goals of creating best-cost enterprises.

Very simply, three enablers that contributed to rapid adoption of offshore outsourcing have been: one, economic availability of bandwidth; two, availability of an economic global workforce; three, economic availability of Internet-based technologies and tools to manage work processes. However, the speed and rapidity of adoption was greatly accelerated by three, very visible outcomes- substantially faster, considerably better, and significantly cheaper products and services, that greatly sharpened a firm's competitive edge. The experiences of the first movers showed that offshore outsourcing of services delivered substantial, tangible benefits.

FROM BUSINESS GOALS TO EXECUTION

Offshore outsourcing is a risky proposition but like any other venture into an unknown terrain, if these risks are anticipated, they can also be mitigated. Irrespective of the nature of the execution, the challenges that a firm faces are similar, and fall in four broad areas:

1. What are your business goals for outsourcing?
2. What do you outsource?
3. How do you pick whom to outsource to?
4. How do you manage the contractor, subsidiary, or joint venture?

It is most important to first define the business goals and reasons behind offshore outsourcing, and to clearly articulate the expected results, and their metrics and measures. These goals and metrics will be milestones, reminders as you make progress on this journey. These goals and metrics should encompass all factors that improve your firm's competitive edge- ROCE, cost, time to market, quality, as well as other issues, such as, customer satisfaction, market share improvement, and contribution to innovation and intellectual property at your firm. At the outset, these goals and metrics will not be perfect, and will be continuously modified, as experience builds through learning.

Some of the business benefits of offshore outsourcing are:

1. Magnify the Power of Cash: Offshore outsourcing can deliver considerable benefits in cost advantages, with immediate savings.
2. Turn Fixed Assets into Variable Expenses: Offshore outsourcing shields companies from the vagaries of highly volatile market conditions, especially downturns. In the offshore outsourcing business model, fixed assets are converted into variable costs, and shedding variable costs are easier than reducing fixed assets.
3. Multiply Productivity: When offshore outsourcing partners are in the opposite end of the globe, productivity multiplies because production becomes a 7x24x365 process.
4. Deliver Triple Economies of Scale, Scope, and Knowledge:
    a. Economies of Scale from offshore outsourcing services are obtained because available knowledge is shared over a number of uses as time passes by, thereby reducing average costs per use.
    b. Economies of Scope are realized because explicit knowledge can be reused in activities and processes across different uses or users. For both economies of scale and scope, the higher the number of uses or users where codified knowledge can be reused, the higher the benefits potentially obtained.
    c. Economies of Knowledge are obtained because offshore outsourcing promotes:
        i. Sharing of explicit knowledge that leads to knowledge combination not mere replication
        ii. Codification in one domain raises the returns of more codification in another complementary domain
        iii. Codification of knowledge creates redundancy to improve coordination at interfaces between activities.
5. Magnify the Firm's Assets: Moreover, firms use offshore outsourcing to leverage growth, to magnify the value of a firm's assets, improving its competitive edge and the ability to respond to changing market forces.[2]
6. Speed Up Innovation: The offshore outsourcing based business model can also help speed up the pace of innovation. Darrell Rigby and Chris Zook[3] found that "companies that collaborate with outsiders on their R&D reap a higher percentage of their total sales from new products than companies that don't collaborate".

ALTERNATIVE PATHS TO OFFSHORE OUTSOURCING

Firms have followed three paths to offshore outsourcing (Figure 1):
1. Build and operate a subsidiary.
2. Subcontract to an offshore contractor.
3. A Hybrid, where a contractor builds the initial outsourcing infrastructure, operates it, owns it (at least partially), and then transfers it to the parent firm.

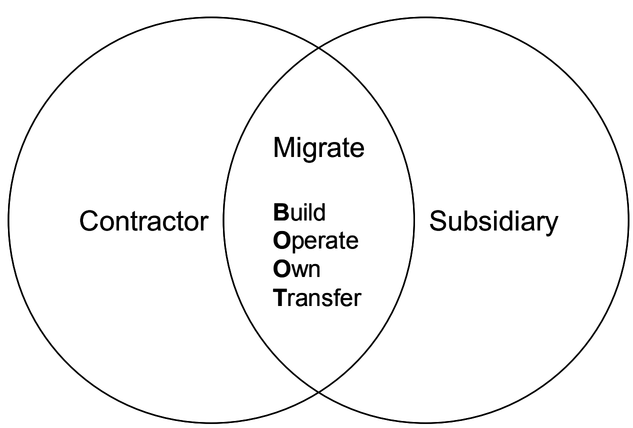

Figure 1: Offshore Outsourcing Models

WHAT TO OUTSOURCE?

Once the fundamental goals behind the initiative have been nailed, the next step is to mitigate the risks of throwing your firm's activities over the transom to a firm- subcontractor or subsidiary- that is most likely to be in another time zone, if not another hemisphere.

Going back to your business goals, recognize that all activities at your firm have multiple dimensions:

1. Core Competency
2. Critical to your market position
3. Cost of the activity
4. Availability of quality people to execute
5. Integration with your business processes

Analysis of your business processes and activities will reveal that your firm has a portfolio of activities that fall into various- high, medium, low- buckets. For example, an activity may have low relevance to your firm's core competency (it is an adjacent one), is not critical to your market position, may have high costs, because there is a shortage of quality people for execution, and is not quite integrated with other business processes. These kinds of activities are prime candidates for offshore outsourcing.

Today, the focus of outsourcing- of Non-Core Analytical and Administrative activities (Figure 2)- has been on discrete, cohesive tasks that belonged to contiguous departments – administrative, customer support, IT, software development, and other such functions. These activities and tasks could be easily identified, carved out, and outsourced to the industry's service firms.

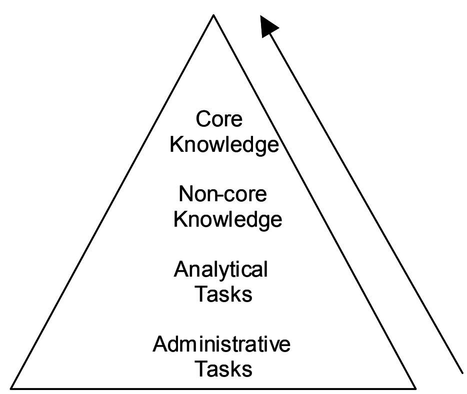

Figure 2: Offshore Outsourcing Trends

The transition process to offshore outsourcing is not without challenges. The secret is to start with tasks and activities that can be explicitly defined and then to tacit ones and finally those that are goal-driven. Transition to this alternative must be accomplished in a phased approach, with the goal of achieving maximum savings over the long run.

Phase one: Start with explicitly defined tasks, where project management and product management are controlled by the client firm. The vendor firm does not have assets dedicated to the client; at this stage, trust in the relationship is low, on both sides. Estimated savings are about 20% to 30%.

Phase two: As trust and communications begin to gel, activities that can only be defined tacitly are transferred to the vendor or subsidiary. You and the vendor/subsidiary begin to share responsibilities for project management and processes, though product management is clearly in your domain. The vendor firm does have some assets dedicated to your projects, and at this stage, trust in the relationship begins to warm up. Knowledge sharing has begun in small ways between your organization and your vendor/subsidiary. Estimated savings are about 30% to 45%.

Phase three: As trust, communications and processes become integrated, tasks that are outsourced are a combination of explicitly and tacitly defines tasks, but goal-oriented tasks are now added to this mix. You and the vendor/subsidiary share responsibilities for project management and processes, though product management is still clearly in your domain. The vendor firm has significant assets dedicated to your projects, and at this stage, trust in the relationship and knowledge sharing between the two entities are high. Estimated savings are about 45% to 50%.

The success of the entire offshore outsourcing program depends on the first step- the selection of the first project- an explicitly and clearly defined one. At this stage, product management, and project management should be securely in the buyer's domain, and there should be realistic expectations of benefits- costs, time, and quality.

SELECTING OUTSOURCING PARTNERS

Whether outsourcing business processes or IT services, the process framework for selecting vendors is the same. However, at the outset, before evaluating a few vendors revisit your business goals and the project that you seek to outsource just one more time, to assure that they are both synchronous.

Recognizing that "explicit specification" is a significant factor for success, use the RFI, RFP, and RFQ procurement process for sharpening your project definitions. Yes, it takes time, but it is worth it. The education and learning you receive are immeasurable in value, and these will substantially improve the probability of success of your outsourcing endeavor. It is okay to use your vendors' knowledge to sharpen your definition, and do repeat your requirements at every step of the RFI, RFP, and RFQ procurement process.

Scan the market to select a few companies to meet your outsourcing needs for, both, short and long-terms, for strategic and tactical perspectives and evaluate them for:

1. Capability- At the core is the task at hand. Focusing on the project, choose a few vendors who have the wherewithal to meet your requirements, for the short and long term.
2. Credibility- Check the track record of the company, especially at executing projects of the type you are contemplating. Do ask for references, not only for the firm but also of the principals of the firm. Follow through with calls to these references; you may receive information from these references that may surprise you, and aid you in your process. Their learnings are critical to your success.
3. Stability- Checking a firm's financials, especially its cash flow, which often reveals insights into its commercial terms with current customers, and its financial viability.
4. Scalability- Recognizing that an offshore outsourcing initiative is a long-term endeavor, the ability of a firm to scale up, to your specific needs, is critical. The firm's size does matter in the long run, but is not a critical shortcoming. Its skill-sets are more important.
5. People- Early in the RFI, RFP, and RFQ process, do insist on meeting the people- the firm's principals, the project manager, and the team that will be assigned to your project; also do visit the facility that will be home to these people. This will greatly enhance your confidence in your selection decision. Paper and electronic transmittals have severe limitations, and personal contact goes a long way in establishing the rapport that is so necessary for successful execution. Also, do check out the expertise, experience, skill-sets, qualifications, degrees, and professional industry affiliations of these personnel.
6. Processes- Successful offshore outsourcing depends on an enormous number of internal and external processes at your vendor firms- for Project Management, Communications,

Security, Quality, Disaster Recovery, and Change Orders to name a few. A systematic, detailed review of these processes' quality, robustness, and, equally important, similarity to and fit into your processes, is necessary. Simultaneously, you should evaluate the kinds of people, skill-sets, and processes that you need to add or modify to manage these processes. There are various models for managing these processes, which go from Single Point of Contact (SPOC), at one extreme, to a fully distributed model, with multiple touch points, at multiple layers. For starters, focus on the SPOC model and gradually move to the distributed model, which depends on substantial technology infrastructures that may be too cumbersome, in the beginning. Have a SPOC for your firm, and insist on your vendor's SPOC to be at your site. This will greatly reduce anxiety and heartburn.

7. Tools/Technology- Assure yourself that your firm and the vendor have the tools and technologies to support your project, its participants, and processes. To avoid future hidden costs, look for proof of ownership of software licenses, hardware, and other hard and soft goods that are critical to your project. Proficiency in using these tools should be checked in the diligence process. Additionally, tools and technologies that will aid your inter-company processes should also be considered. Ask questions about technologies that support collaborative processes. They will range from simple to sophisticated ones. Moreover, do check on how the firm captures economies of scale, scope, and knowledge in tools to further reduce costs.
8. Communications- Coordination with your global workforce will bring to the forefront many cultural and linguistic difficulties that can be overcome by establishing personal rapport with the team- meet them in person or electronically, so that they can associate a face and expressions to the voice or the email that they constantly interact with. English is lingua franca in most businesses but the language, especially slang, is not interpreted the same way around the globe, so avoid slang in your communications. Having an onsite SPOC greatly enhances communications and learning. However, do not avoid written communications because we do need a paper and audit trail, for those finger pointing "he-said-she-said" situations that are bound to emerge. Just keep these written, e-mail communications short, to the point, and try to maintain context to the best of your abilities.
9. Commercial Terms- At a minimum the RFI, RFP, and RFQ procurement process should comprehend Lifecycle Costs, All Deliverables, Confidentiality Issues, Financial Terms, Legal Issues, Intellectual Property Ownership, Liabilities, and other issues that are important to you as a buyer. If the goal is to create a subsidiary through a hybrid model, the migration path, milestones, and terms of transfer should be clearly stated. Watch out for lifecycle costs!
10. Compatibility- At the end of the day, organizational chemistries must match because both firms are going to be partners for the long haul. Both the buyer and the seller will have to adjust and compromise along the way, and anticipating the degree of adjustment is of prime importance. References are key in understanding this soft issue, which many technically oriented organizations may ignore to their detriment.

MANAGING OFFSHORE VENDORS TO MAXIMIZE VALUE

After you have selected your initial project and vendor, managing them requires a mindset on your part, as the buyer:

1. Constantly focus on business goals, not just tactics
2. Remember that you are playing a long-term game; if you are doing this for just immediate gains, stop playing.

Successful management of the offshore resource depends on few key parameters:

1. Spend some time on detailed design of people, process, and technology infrastructure required for your deliverables, at both ends – in your organization as well as in the off-

shore entity. If you have spent some time on these- people, process, technology- in the vendor selection process, you are almost there. However, now's the time to add specificity and details.
2. Project Management – do not underestimate the importance of this discipline. Set up project management offices at both ends, assigning senior members at your firm as well as the offshore firm as SPOCs- this is a key contributor to your success.
3. Communications is vital to the success of this endeavor. At the outset, rely on the SPOCs to facilitate all communications. However, this is an inefficient process and as confidence grows, encourage multi-level, distributed communications rather than funneling them through a SPOC. If you are going the subcontractor route, insist on having a senior member of the execution team to be present at your location.
4. Insist on metrics, measures, and benchmarks- tying them back to your business goals.

Thus far, you have just gone through the first phase of the offshore outsourcing process, and the estimated cost savings would be in the 20% to 30% range.

As you and your firm get more comfortable with the performance of your vendors, and your mutual people, processes and tools mature, it is time to move to the next phases of offshore outsourcing- driven by tacit definitions of projects, and to goal-driven ones.

Recent studies suggest that productivity gains in a production network (or value chain) are maximized when companies are willing to collaborate in unique ways, often achieving advantages by sharing resources, knowledge, and assets.

Jeffrey Dyer[4] found that, in the automotive industry, the leanest, best performing value chain usually wins. There are four major factors in the success of a production network. These are:
1. Designing the boundaries of the firm or the “governance profile” of the production network. Toyota's managers avoid vertical integration, except where it is required for differentiation in the market, and rarely used arms-length relationships when working with external firms.
2. Dedicated Assets: Investing in dedicated or relation-specific assets and resources. Toyota created the conditions that encouraged suppliers to make investments in assets dedicated or tailored to the production network, share valuable knowledge with other members of the production network, and trust Toyota and other members of the production network. The investments in dedicated assets resulted in lower costs, faster product development cycles, and higher quality.
3. Knowledge Sharing: Creating inter-organizational knowledge-sharing routines. These knowledge-sharing activities resulted in a production network that learned faster than other production networks, about best practices in production, quality, and management.
4. Long-Term Relationship: A commitment to the long-term creates high levels of trust throughout the extended enterprise. This maximizes flexibility and responsiveness, resulting in a production network with lowest interaction and transaction costs.

A combination of these four factors enabled Toyota and DaimlerChrysler (which later emulated Toyota's model) deliver impressive results, outperforming loosely integrated production networks.

Combining Dyer's factors of success with the phased approach would deliver increasing cost reductions, over time, as shown in Figure 3.

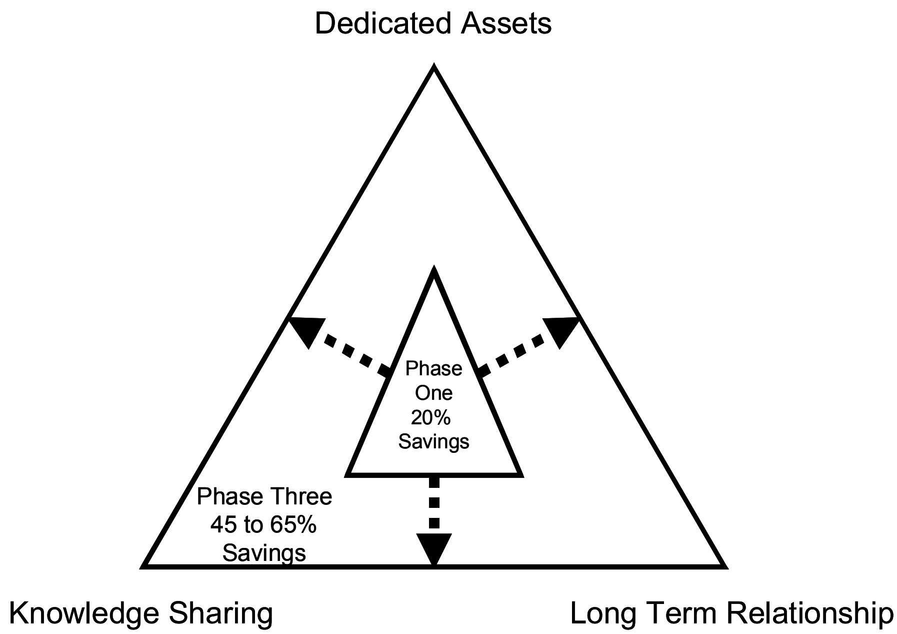

Figure 3: Maximizing Savings through Outsourcing

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APPENDIX: SUCCESSFUL OFFSHORE OUTSOURCING