The Reality of Insourcing – Also Referred to as Backsourcing

Introduction:

There is a growing trend where organisations are taking previously outsourced services back in house and claiming that substantial cost and quality benefits have been enjoyed as a result. But can it be as simple as that; surely the outsourcing company's promises of significantly reduced costs and improved service levels brought about by access to Best Practice, the Best Staff, Offshore Resources and effectively Unlimited Scalability must count for something.

This paper examines the true reality behind the outsourcing market and why it has proved so successful with staggering growth over recent decades. It also explains why the Backsourcing trend is set to continue and indeed accelerate in the future.

Outsource or Insource:

CIO Plus' general assertion on mainstream outsourcing, long seen as a tactic of choice for CIOs, is that wholesale outsourcing ought to be one of last resorts for an organisation of sufficient critical mass. If an organisation's IT or BPO functions and its leadership is good enough, then it should be delivering these services to the organisation itself; and if it's not, then time and resources should be put into making it so. If you opt to 'do it for yourself' following Best Practice, this can lead to a significantly lower achievable cost as the outsourcer's gross margin and unnecessary interfaces are avoided and greater flexibility and control is retained which can lead to improved service levels.

However, there are several exceptions to this general principle where outsourcing could definitely be the right solution:

- Partaking of centralised services and only incurring marginal costs.
- Utilising lower cost offshore resources.
- Access to scarce skills.
- Avoiding large capital intensive investments to free up funds for alternative use.
- Sharing services between organisations.

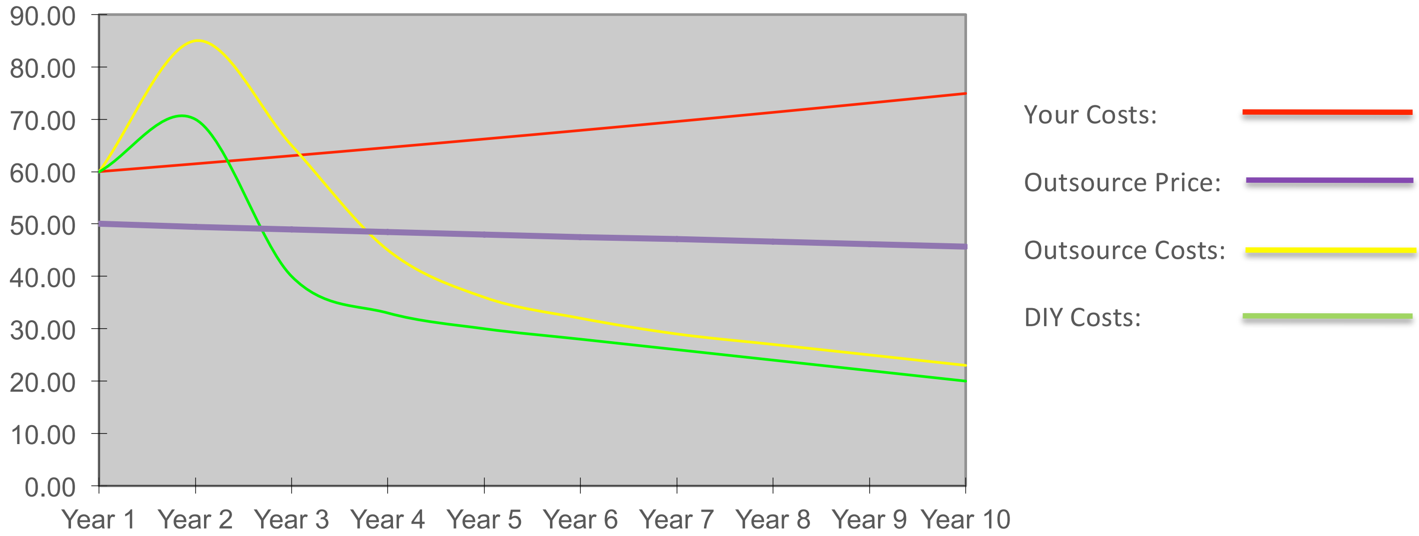
Sharing IT resources between organisations is particularly relevant to the Public Sector where Hospitals, Police, Councils etc... stand to gain substantial benefits in terms of improved service levels and reduced costs. Additionally, new cloud models are introducing a 'pay as you go' approach to alleviate some investment decisions.

So why did we reach our general conclusion and more importantly, what evidence do we have to back our assertion up? Consider the diagram below. The red line represents a company's IT spend trajectory and the outsourcer promises a cost following the purple line with improved SLAs. Note that there is also an immediate reduction in costs of 10 units (60-50).

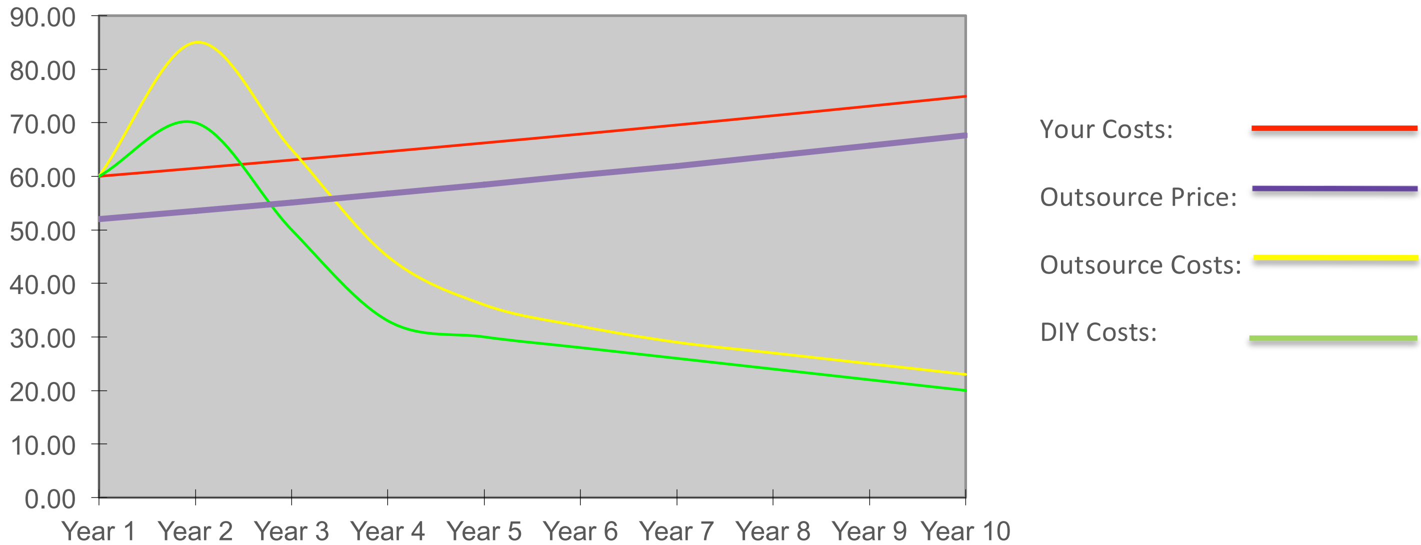
But in reality when the outsourcer takes on the contact they inherit the cost base of the company (the yellow line) and if they are going to improve efficiency they have to invest to bring running costs down by adopting best practices and removing duplication. They break even at the end of year four and then they are in profit for the remaining period of the contract.

However, if the client is ‘good enough’ to do it for themselves they can reach a lower cost line (the green line) as they do not have to cover the outsourcer’s gross margin and ‘unnecessary’ interface costs (usually managerial and commercial between the client and supplier) are avoided.

Before proceeding with an outsourcing deal, we always advise clients to benchmark the proposed contract by considering a ‘bottom up’ build based on Best Practice; and definitely not by comparing a range of re-tender prices all of which will include the unnecessary additional costs.



But this diagram does not tell the whole story as it is unlikely that the contract that has been struck will cover all the services that need to be supplied. Frequently contract variations are raised after signing and the purple line moves up to increase the price. So the final outcome is represented by:



This is a situation that we find all too often in practice. The outsourcer has reduced costs for the client, but not by the amount initially envisaged when the contract was signed; and certainly not by the amount that a proficient client could have achieved by doing it for themselves.

Before you enter any outsource contract, ask yourself if any of the exceptions outlined above apply; and if they do not, make sure you fully understand the detail of how the promised improvements and savings will be delivered. Remember, all the negotiating power is in the client's hands until the contract is signed and then unfortunately, the 'boot is firmly on the other foot'.

Why has the Outsourcing Industry been so Successful?

Outsourcing can deliver efficiency improvements and cost savings, but very rarely do they deliver best value. What CFO would not advocate this approach for an immediate short-term benefit and a genuine belief that further substantial savings will also be delivered. The true question that should be asked is how those longer term savings will be delivered and whether or not they will ever materialise.

This state of affairs has been perpetuated as, once a company has outsourced a substantial part of their capability, they denude themselves of the ability to extricate themselves from the contract and elect to try to improve their lot through a competitive re-tendering process which extends the outsource treadmill.

Offshore or Onshore?

There is little doubt that utilising the correct mix of offshore resources can bring substantial performance and cost benefits, but is it always necessary to obtain access via a third party?

The emergence and success of offshore outsourcing was primarily driven by the benefits of labour arbitrage with a simple lift and shift of the clients' service using their tools and processes but employing low cost staff to deliver in a client dedicated environment. The amount of the employment differential was attractive enough for clients to be satisfied with the savings generated and also for the outsource suppliers to enjoy healthy margins.

Since the most recent global recession, many companies are again evaluating the cost of their IT and BPO services and there is a growing realisation that the Third Party Offshoring Model may not be the key to cost efficiency that it once was. Rather than re-tender their contracts and try to obtain a better deal, many forward thinking organisations are carrying out bottom-up benchmarks and reaching the conclusion that it would be cheaper and more effective to 'do it for themselves' with the added advantage of regaining control of their IT and BPO capabilities. Companies including AstraZeneca, Daimler, Equiniti, Morgan Stanley and Sainsbury's have already declared their intent to build their own captives with reported expected savings of 40% plus, coupled with improved service levels, increased flexibility and better control.

But the question that is often asked is that it may be OK for the big boys, but is it OK for me and is my company too small to adopt this approach?

Circumstances will vary from case to case, but our general rule is that the critical mass to achieve a successful offshore presence lies in the range of 75 – 100 staff. Once IT and BPO have been considered most companies will find themselves potentially satisfying these requirements. The smallest successful installation that we know about contained 30 staff but operated in a very specialist area with the requirement for specific niche skills. If you want to understand the reality of setting up a Global In House Centre, please refer to our White Paper on the subject which can be found by clicking here.

The Analysts' View:

Gartner has reported that 42% of medium and 56% of small business contracts are backsourced once the contract has been discontinued. They estimated that the typical cost of insourcing is between 2% and 15% of the annual contract value. This appears well justified when you compare against typical gross margins of between 40% and 60%.

Deloitte's recent Global Outsourcing and Insourcing Survey reported that:

- 48% of contracts terminated early.
- 34% brought services back in house.
- 79% were satisfied or extremely satisfied with the insource.

Typical reasons given for insourcing were 'improved customer experience', 'improved control' and 'reduced costs'.

Who is Backsourcing?

Some of the companies that have successfully backsourced or announced their intention to are:

- AstraZeneca to reduce IT costs by 50%
- Daimler to save $200m pa.
- Sainsbury's to save £440m.

A more complete list can be found on our website by clicking here.

The Facts and Figures:

Most outsourcing deals contain a 'Terminate for Convenience' clause where termination can be effected by paying a 'sliding scale' of compensation which reduces the further into the contact you are. In our experience, the savings are typically so large that it is nearly always worthwhile triggering this clause to gain the additional enhanced control and improved SLA performance.

We typically expect improved SLAs and minimum savings of 40% and the costs of achieving this are in line with Gartner's predictions of 2% - 15%, with smaller contracts higher up in this range.

Why CIO Plus?

CIO Plus specialises in providing independent impartial advice based on Best Practice and our team has delivered many successful backsourcing projects that have materially improved client profitability. We have a proven methodology and can provide full life-cycle coverage including:

- Strategy, Business Case & Planning
- Contract Termination Negotiation & Exit
- Rebuild of In House Service
- Recruit, Train & Knowledge Transfer
- Global In House Centre Set Up
- Stabilisation & Optimisation

Here are just some of our clients that we have helped improve service levels and reduce costs:

- SSE – Backsource & Transform:
  - 65% reduction in IT costs.
  - 140% rise in share price.
- QinetiQ – Backsource & Transform:
  - 50% reduction in IT costs.
  - Nominated for ‘Large company Turnaround of the year’.
- Wates – Backsource & Transform:
  - 50% reduction in IT costs.
  - Doubled profits.
- Equiniti – Backsource & Transform:
  - 70% reduction in IT costs.
  - 15% increase in profitability.

If you are interested in discovering if this is the right direction for you, or you want more information about this topic, please get in contact.