



Making Outsourcing and Offshoring Work

by Bublu Thakur-Weigold and André Kuper

After the rush to outsource, the realities of operating in a global labor market start to sink in. Reflecting on a variety of experiences, multinational companies are actually paring down wholesale efforts to outsource knowledge-based activities like IT.¹ Although it is still imperative to ask "Should we outsource or offshore?" the oversimplifications implicit in the question gloss over all the business dynamics and success factors that must be grasped in order to make the decisions work out as hoped.

A number of factors inform Hewlett-Packard Company's strategic decision making. As our products increasingly become a range of commodities, the commoditization of the underlying IT infrastructure (like that of the manufacturing base decades before) is actually inevitable. At the same time, the competitive differentiation of how that infrastructure is delivered in the customer experience becomes a key to survival. This apparent paradox is one of the challenges that a maturing IT organization must face.

Like the supply chain, procurement, and logistics functions before it, the role of IT is evolving as the enterprise it serves becomes increasingly specialized and extended. The specialists who have grown successful by managing all aspects of a project inhouse must deal with new cost pressures that coincide with the demand for faster, better, and more focused business results. In order to mature into enabling partners of their business, IT must resist the temptations to merely manage cost and resources and instead must create innovative processes that cannot be reproduced anywhere else in

the world, for any price. Not only will basic IT asset development be commoditized, but project execution as well, which means that the core competencies that cannot be delegated are actually sophisticated forms of program management. We claim that success in outsourcing and offshoring hinges on managing the handoffs between the players in the IT ecosystem. The ultimate success factor is a focus not on resources or costs, but on business results.

ACKNOWLEDGING THE "FLAT" WORLD

Despite its comparatively late arrival on the scene, *The World Is Flat*,² the popular book on globalization by *New York Times* columnist Thomas Friedman, has had considerable influence on management decision making, and HP was no exception. Although the book is an eclectic blend of anecdote, economic reporting, and the history of technology, with little management theory, leaders were swayed into hasty labor arbitrage,³ lest they miss the boat on grabbing talent and cost advantages around the world.⁴

Friedman's assumptions were both explicit and unspoken:

- Labor is a commodity: each worker is an interchangeable unit of talent and diligence.
- IT is a commodity: each asset can be built for any company by anyone anywhere.
- Technical connectivity means that no other barriers to productivity exist.

¹See, for example, "Size of Global Outsourcing Market Shrinking," *IndiaTimes Infotech*, 2 November 2006 (http://infotech.indiatimes.com/Tech_News/News/Size_of_global_outsourcing_market_shrinking/articleshow/297569.cms); Lynn Tan, "Outsourced IT to Return Home," *ZDNet Asia*, 6 November 2006 (www.zdnetasia.com/toolkits/0,39047352,61965103-39094245p,00.htm); and Sunil Chitale, "Seven Trends in Offshore Outsourcing for 2007 and Why They Matter," *Off Shoring Times*, 8 November 2006 (www.offshoringtimes.com/Pages/2006/offshore_news1329.html).

²Thomas L. Friedman, *The World Is Flat: A Brief History of the Twenty-first Century*. Farrar, Strauss and Giroux, 2005.

³Labor arbitrage is defined as finding the lowest-labor-cost location for creating a commodity product or service.

⁴*The World Is Flat* is the number one recommended "management" book in the human resources field, and its impact should not be underestimated. It did not necessarily change existing trends in outsourcing, but it provided a simple and anecdotal explanation of why labor arbitrage was the way to go.

These oversimplifications sometimes resemble reality — but not always. The gap between expectation and financial outcome can be fateful. With hindsight, overly confident declarations of “The world is flat” can become bitter double-entendres for trained engineers, who *should* have known better.⁵

Managing IT staff, cost, scope, and business value, to mention only the basics, will always require careful planning and process innovation — HP traditions that are being continued by the new CIO Randy Mott. Although the “flat world” metaphor tempts even seasoned IT managers into skipping due diligence, the decision to outsource or offshore (they are not the same thing) is not a given. If your particular business case will benefit from working with partners, however remote, the handoffs and risks must be deliberately defined and actively managed.

THE RULES OF ECONOMIC SELF-INTEREST STILL APPLY

Experience has shown that, without rigorous enforcement of predefined consequences for all parties, the offshored team will never be a stakeholder, but will instead gain an incentive to jump ship at the moment the project needs their expertise most.⁶ IT managers — who in the past decades have witnessed the dismantling of inhouse IT teams while consulting services boomed — will be familiar with the fact of conflicting interests. In order to grow and survive, third-party vendors must

maximize billable hours while learning as much as possible in the course of an engagement. Once they have completed your project, in as *much* time as possible, the consultant will be happy to move to your competitor’s project and sell that know-how as an industry “best practice.”⁷ Your company’s project will, however, focus on other objectives — on time, on budget, within a scope that generates business value — in order to survive in your market.

Since the business objectives of both parties are legitimate and inescapable, it is amazing how many IT experts are willing to believe that the rules of economic self-interest no longer apply in the so-called flat world. No elite graduate who survived the draconian conditions of entrance (and exit) from an Indian Institute of Technology will be eager to assume the role of “cheap offshore labor” on your project. That hyper-competitive denizen of the country’s intellectual elite will feel entitled to the most interesting variety of engagements, with an ever-growing salary and development program. The very talent and unbounded ambition that you originally sought to secure at a bargain basement price may turn into an incalculable cost factor.⁸

A further complicating factor in both outsourcing and offshoring is the distance added between customers and those people who directly influence how your customers perceive you. The feedback loop — which is a company’s first line of defense in addressing problems — stretches to the breaking point. Handoffs add cost in

⁵See, for example, Rachel Beck, “Short-Term View Could Haunt Investors,” Associated Press, 21 November 2006; and “Short-Term View Limits Rewards of IT Strategy,” *PC World*, 8 June 2005. A 2005 survey of more than 400 financial executives revealed that 55% would delay starting a project with a positive net present value in order to avoid falling short of quarterly consensus earnings. So even if the evidence of financial experts suggests a better solution, 78% would rather forgo that opportunity for short-term perception management (see John R. Graham, Campbell R. Harvey, and Shiva Rajgopal, “The Economic Implications of Corporate Financial Reporting,” *Journal of Accounting and Economics*, Vol. 40, Nos. 1-3, December 2005, pp. 3-73).

⁶See, for example, “Dealing with the Realities of Turnover,” *IT Business Edge*, 23 November 2005. Employee turnover numbers in the business process outsourcing (BPO) industry speak for themselves. According to a private industry report, the 2004 attrition rate was 35% in the nonvoice outsourcing industry and 45% in call centers. The turnover rate in the tele-service industry in the US is even higher, with average turnover rates between 50% and 70% (Aberdeen Group, quoted in *Turnover Analysis of the Tele-service Industry on Cape Breton Island*, Enterprise Cape Breton Corporation, September 2006).

⁷This is not innuendo or hyperbole. Consider, for example, New Balance’s battle with its contract manufacturers (see Roger Parloff, “Fighting Brand Ripoffs — New Balance’s case shows how hard it can be to protect your intellectual property when your products are made by subcontractors overseas,” *Fortune*, 27 April 2006) and the counterfeiters who created a “shadow” version of NEC (see David Lague, “Next Step for Counterfeiters: Faking the Whole Company,” *New York Times*, 1 May 2006). Moreover, the brand-building activities of former contract and original design manufacturers and their offering of “consulting” services are demonstrations of their lack of respect for their customers’ IP (see William J. Holstein, “Middleman Becomes Master: Wal-Mart watch out — giant Hong Kong trader Li & Fung boasts an information system to beat,” *Chief Executive*, Vol. 182, October 2002; Sally Beatty, “Brands on the Run: In Fashion World, The Anonymous Catch the Fabulous,” *Wall Street Journal*, 17 September 2003). Counterfeiting and extra shifts are a real problem for multinational companies (see Parija Bhatnagar, “China: Your Company Name May Not Be Yours,” *CNNMoney.com*, 7 March 2006).

⁸Again the hidden costs of employee turnover are the crux here. See, for example, Andrew N. Garman, et al., “Ready-to-Use-Simulation: The Hidden Costs of Employee Turnover,” *Simulation & Gaming*, Vol. 36, No. 2, June 2005, pp. 274-281; and Stephanie Overby, “The Hidden Costs of Offshore Outsourcing — Moving jobs overseas can be a much more expensive proposition than you may think,” *CIO*, 1 September 2003.

the form of lead time and additional resources: they always require special skills to manage. Success will depend on how well you grant autonomy to the local experts who are in the best position to judge the situation. Their decisions must subsequently be made visible in the context of the larger ecosystem, to both enforce accountability and avoid misreading local actions. A proactive and flexible workforce that permits individual workers — whether employees of your company or those from a third party — to take pride in their work will fuel the innovative culture so critical to survival in a commodity environment. None of this will be possible without guidance and a support framework from an enlightened management.

The fact that intellectual property (how your company computes a price, divides up a region, structures its logistics networks, the list goes on) is something you want to keep within your company's walls contradicts any claims that IT doesn't matter. And yet, this doesn't mean that commoditization of IT assets is *not* happening. Increasingly, software modules can be (and are) implemented as such. However, assuming that IT therefore becomes a commodity is overstating the phenomenon.

The IT organization that adopts a one-size-fits-all approach will be sucked into the flat world's spiral of wage deflation. This is why, even in a commodity environment, IT needs to be a process innovator. Instead of merely managing cost and remote resources, all of which are execution details that can be handed off to others, IT professionals should focus on both lowering the total cost of ownership of IT assets while defining value for the enterprise they serve. The maturity of that level of program management implies that IT needs to become partners with the business in defining strategic value. Just as commoditization of products requires operational excellence with differentiating features, the task of IT now shifts to delivering the value that matters to the company it serves.

HP'S RESPONSE

Because we sell commodities at razor-thin margins, HP's operating models, including those of IT, must be uniquely competitive. Faced with the Western rush to move work into low-cost countries, HP did not proceed

with business as usual. HP is a multinational company that needs to adjust its fixed costs to the local market conditions. Furthermore, our CIO wants to reduce the cost of IT maintenance to 20% of the IT budget. These very aggressive cost-cutting and innovation goals required reducing staffing levels and reexamining initiatives and projects. To ensure business continuity, it was important that the change from a fully insourced but expensive IT infrastructure to a partially outsourced one (combined with an HP-owned but partially offshored IT staff) occur in an orderly fashion. Labor cost — often synonymous with headcount — is but one component of this long-term initiative.

The current IT transformation at HP has set centralization as one of the goals on its path toward rationalization and competitiveness. The pendulum swing from a long tradition of decentralization to centralization (or from "anarchy to martial law," as one IT professional sardonically put it) requires strong leadership. And leadership with a vision is key: HP aims to restore IT as a core and proprietary competency, while exploiting the cost benefits of global arbitrage. Centralization retrieves control, establishes accountability, and ensures continuity of key projects while retaining intellectual property (without constant legal vigilance) inhouse.

ENSURING ACCOUNTABILITY

As the industry pendulum swings back from IT outsourcing to IT offshoring,⁹ teams may naively assume that the "reappropriated" resources are now automatically part of "the team." In reality, however, both outsourcing and offshoring require answering the same question: how do you ensure the other party will execute against your objectives while pursuing their own? Managing conflicting objectives must become a way of life, whether you are dealing with an employee in another country or with an employee of another company. Ensuring that all objectives are well defined, documented, and verified is the key to success. This is only possible when strong high-level sponsorship validates business needs and translates them into thoroughly planned systems requirements. Scrupulous verification and validation of ongoing progress should be an integral part of every project, no matter how small.

⁹Here we define "outsourcing" as the use of a third-party provider for products and services, while "offshoring" denotes the sourcing of services or products from another country. In the case of offshoring, the personnel may be company employees or third parties. HP, like most other multinational companies, has employees in other countries such as India and China that provide products and services for HP in other markets. So in the context of HP, the majority of offshore IT professionals are HP employees. In terms of bridging the time zone, cultural, and communication gaps, the process for dealing with offshore employees is no different than for outsourcing. The main difference will be in contractual risk/reward sharing and penalties.

Professional verification and validation means that you take accountability seriously. Often program and project managers assume that ambiguity provides them with flexibility. In fact, ambiguity of objectives is a recipe for disaster. It allows the offshored or outsourced party to manage the project to their goals without delivering on the flexibility you think you are paying for. If your objectives, together with the performance indicators that track them, are casually defined, you may still (irrationally) expect the other party to work in your best interest rather than their own. But, why would a hyper-competitive Asian engineer, evaluated by a local manager, sacrifice his or her own interests if you build in leeway in the form of vague objectives and metrics? In outsourcing, it is the professionally drafted contract that ensures that the third party remains compliant. And although this procurement expertise may not be a core competency of experienced IT engineers, we advocate watertight statements of work as an integral component of any offshoring initiative.

ENABLING THE "ARM'S-LENGTH" RELATIONSHIP

Ensuring success in a globally operating virtual team requires autonomous local decision making. To achieve this, you need well-defined handoffs between players that allow this autonomy, while guaranteeing an expected outcome. Such an arm's-length approach creates a relationship that is focused upon results that produce few or no surprises. Scrupulously negotiated handoffs enable you to steer clear of the pitfalls of micromanaging both deliverables and people in a remote location. Uncritically augmenting your project staff has a known set of problems, such as the cherry-picking of scarce resources, which results in staff turnover at the cost of intellectual property, burnout, and general team dissatisfaction. These ills can be attributed to treating the third party as second-class citizens by denying them their right to manage their own talent. Worse still, by focusing its efforts on micromanaging remote resources, the inhouse IT organization myopically overlooks its own opportunity to move up the value chain and become a partner to the requesting business.

So what should a sophisticated IT team be doing in an outsourced situation? Although it sounds deceptively simple, the new role will be to manage handoffs, materials transfer, information, risk, and rewards. Different cultures, both organizational and geographical, create gaps in understanding. Multiple time zones will introduce delays, while the accumulation of implicit information will demand proactive management. Input will

be distorted and delayed, while issues will be amplified. A clear definition of roles and responsibilities (including who commits to which inputs and outputs) will go a long way toward overcoming often banal challenges.

However, mere formal "contractual" specifications will be insufficient to make outsourcing or offshoring work. The only way to create sustainable success is to institutionalize collaboration. In the context of employees in a different country, this should be part of the metrics and incentives of the local and remote employees and their managers. When dealing with a third party, it is about managing expectations very early in the negotiation phase, including collaborative metrics and incentives in the contract, and actively and rigorously validating and verifying deliverables.

A "control tower" can guide the transfer of information, materials, and finances between different locations in the value chain — the entire ecology of people, processes, and organizations that create agreed and well-defined deliverables. As with air traffic control, different people will control the flight path of the project at different times, and this control needs to be transferred in a well-defined and governed way, avoiding delays, distortion, and amplification of issues. The control tower function is a value differentiator and the opposite of a commodity job. Managing handoffs in a network of dependencies requires unique knowledge and skills, which are the distillation of a company's intellectual property. By differentiating IT in a commoditized labor market, this strategic control point will secure its future.

MODERN MATURITY

Unfortunately, the road to success is rocky. One of the challenges HP faced was how to make IT teams aware of intuitive but destructive behaviors (micromanagement, staff augmentation, ambiguous directions, incomplete metrics, insufficient validation of deliverables, etc.) and reorient them to where they need to be to achieve success in outsourcing.

To expedite this education, we developed a simple maturity model (see Figure 1), which represents an organization's ability to maintain an arm's-length relationship while driving business results. We interview key stakeholders — people who can drive change or prevent it from happening — and rate them on their resource and delivery management skills. Each axis represents 10 maturity levels. An individual's rating is perception based and linked to the interviewee's answers to a set of questions. These questions explore

the business context, performance metrics, the main initiatives and projects, success metrics, attitudes toward outsourcing and offshoring, challenges and opportunities, and expectations. We plot the rating of each stakeholder in the maturity matrix while maintaining anonymity. The resulting scatter plot shows an IT organization what it must do to systematically progress toward becoming an indispensable business enabler.¹⁰

COMMODITIZATION AS OPPORTUNITY

Operating in a global, increasingly commoditized environment requires IT organizations to manage their IT assets differently. Innovation lies not just in creating new assets, but also in driving the cost of IT down over time. Outsourcing and offshoring success depends on an arm's-length relationship that focuses on results and managing handoffs. IT organizations should avoid a one-size-fits-all approach and cherish local autonomy, while maintaining end-to-end visibility. One of the outcomes of outsourcing in other professions has been an increased professionalism in managing third parties and the delivery of differentiated business value. Commoditization represents a huge opportunity for IT to become a business partner and not merely a cost center.

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André Kuper initiates behavior changes at HP. His focus is on capturing and diffusing internal and external best practices. He develops and delivers custom training to address business needs in global operations. Mr. Kuper is an expert in supply chain management processes and has extensively published and presented in this field. Every year he runs the MIT Beer Game for Stanford University and is a guest lecturer on uncertainty management for Stanford's Operations Research students. Prior to joining HP, Mr. Kuper worked at the Applied Low Temperature Lab at the University of Twente, the

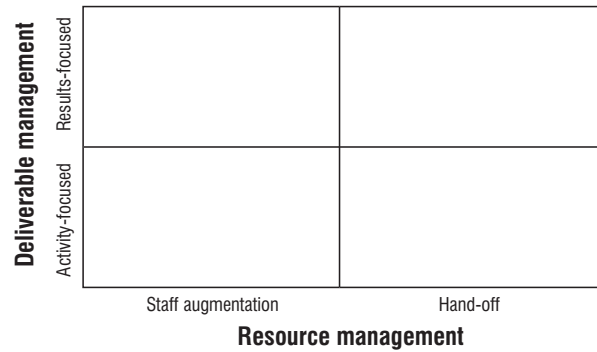


Figure 1 — Our maturity model represents the behavioral tendencies around the outsourcing and offshoring of IT project. This qualitative depiction drives change by capturing existing, unexamined attitudes towards deliverables and resources. The intent of the assessment is to establish a focus on results by managing handoffs.

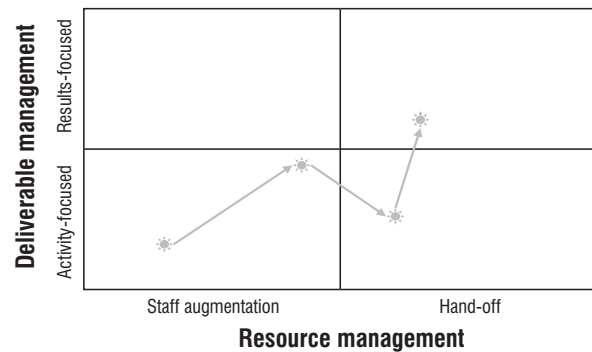


Figure 2 — An example of the evolution of organizational maturity when outsourcing manufacturing of a product that became a low-price commodity (benchmark study).

Netherlands, modeling currents in granular superconductors. This experience allowed him to understand and model similar complexity in supply chains. Mr. Kuper also worked for Andersen Consulting ECC as part of his training in change management and the application of technology for adult learning. He has master's degrees in applied physics and in instructional systems design, both from the University of Twente, the Netherlands. Mr. Kuper can be reached at andre.kuper@hp.com.

¹⁰We use the same matrix to illustrate the journey that manufacturing outsourcing has made. Then, instead of indicating the maturity of individual stakeholders in the organization we work with, we use an average to indicate the organization's maturity at different points in its outsourcing lifecycle. Figure 2 shows an example of four stages of outsourcing for an organization we benchmarked. Stage 1: transfer existing manufacturing to a third party (assets, including personnel transferred); Stage 2: Assets relocate to a contract manufacturer facility to improve resource utilization (buildings, people, materials, and manufacturing tools); Stage 3: Company decentralizes execution but retakes strategic part procurement; Stage 4: Integrated manufacturing of low-cost products in a low-cost location.