



A Society of the Technology Association of Georgia

White Paper

The Economics of Business Process Outsourcing: Measuring the potential impact for high technology organizations

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Introduction

Outsourcing is an age old management practice of adding specialized expertise where needed to help management run or improve an organization.

Today, Business Process Outsourcing (BPO) is a burgeoning business generating billions of dollars in revenues and at least that in efficiencies and cost savings for progressive organizations. Outsourcing now has many dimensions to fit the globalized world we live in. Terms like 'offshoring,' 'insourcing' and 'shared services' are becoming part of a global business lexicon that defines the multitude of options a company has to improve its operations.

The decision to outsource is often made in the interest of:

- lowering operational costs,
- redirecting existing staff energy to allow more direct attention on the core competencies of a particular business, or
- making more efficient use of labor, capital, technology and resources.

For large, global organizations the practice of using business process specialists is well established. The economic advantages of outsourcing have been recorded and examined closely, especially for the larger organizations.

But what can a small or midsize technology company expect to gain from BPO?

The Tax and Finance Society of the Technology Association of Georgia (TAG) has brought together a panel of executives from a broad range of organizations to examine this topic in some detail. The objective of the research and discussion is to help empower executives of growing technology companies to understand how BPO can help their organization grow profitably. The seminar, held in April, 2011 examined many aspects of BPO, exploring such areas as:

- The state of the BPO market
- The key benefits of BPO
- The impact of BPO on stages of high-tech company growth
- The financial impact of BPO
- Guidelines on what functions to outsource

This white paper is a compilation of research presented at the seminar.

Business Processing Outsourcing for High-Tech Companies

Getting Comfortable with BPO Terminology

"Outsourcing" can be defined as the hiring of an outside company to perform a task that would otherwise be performed internally by a company, organization or government agency—generally with the goal of lowering costs and/or streamlining work flow. Outsourcing contracts are often several years in length.

"Offshoring" refers to the rapidly growing tendency among U.S., Japanese and Western European firms to send both knowledge-based and manufacturing work to third-party firms in other nations. The intent is to take advantage of lower wages and operating costs in such nations as China, India, Hungary, the Philippines and Russia.

"Captive offshoring" is used to describe a company-owned offshore operation. For example, Microsoft owns and operates significant captive research and development centers in China and elsewhere. The goals of captive offshoring include greater company control through direct ownership, along with lower operating costs and the ability to utilize highly educated local workforces.

"Insourcing" refers to situations where an outsourced services provider moves into, and sets up shop in or near, a client company's facility. For example, it is common for major companies to sign agreements with IBM Global Services, EDS, Perot Systems and other outsourcing firms whereby these firms take over and operate a client's internal computer department.

Definitions Provided by Plunkett Group

The impact that Business Process Outsourcing (BPO) has had on business over the past two decades is impressive. According to Plunkett Research, outsourcing has reached over \$500 billion as a global industry, with the largest portion of revenue created in the logistics, sourcing and distribution services sector. The second largest sector is information technology services, including the creation of software and the management of computer centers. Another major portion lies in areas such as call centers, financial transaction processing and human resources management.

Global 2000 companies have been the largest beneficiaries of BPO. This is in part due to their ability to leverage large scale deals that produce the best economies of scale.

The Hackett Group, a leading strategic advisory firm, suggests that Fortune 500 organizations could see a potential benefit of \$116 million across the SG&A (selling, general and administrative) functions. "In total, the SG&A globalization could net the Fortune 500 annual savings of \$58 billion, and impact 1.47 million jobs. While about half of the saving and staff impact is in IT, significant opportunities for cost savings and staffing globalization also exists in finance, HR and procurement.

"Simply put, potential cost savings, combined with the quality and capability of talent available in these markets are helping to change the entire business process sourcing analysis."

Estimated savings based on leveraging low-cost country business process sourcing

	Annual Savings (\$ millions)	Number of Staff Impacted	Functional Activities Offering Largest ROI Opportunities
IT	\$58.5	1,223	Application Mgmt; Tech. Infrastructure
Finance	\$32.1	1,045	General acctg. and external reporting; Cash disbursements; Revenue cycle activities
Human Resources	\$15.6	390	Data mgmt reporting and compliance; Total rewards admin.; Payroll admin.
Procurement	\$9.9	275	Purchase order process; Sourcing Execution
Total per Co	\$116.1	2,933	
Totals	\$58 billion	1.47 million	



The rationale for buying external business process management as a service is well documented.

- Gain access to expertise in units versus staffing an entire function internally (reduction in cost)
- Allowing staff to focus on core business functions (i.e. product development, service delivery, partnership building)
- Reduce growth risk (external costs are easier to reduce than staff)
- Increase flexibility (ability to adapt to changing market conditions quickly)

The potential impact for small and midsize organizations is equally strong. According to Gartner Group, the market value of BPO for midsize companies is more than \$15 billion. Gartner notes that cost savings for midsize organizations range in the 10-to-40% range.

As high-tech companies grow and mature, they have a unique opportunity to take advantage of the business process knowledge base that exists in the world of BPO. To accomplish this, they need to understand:

- How the economies of scale work to their benefit
- How the management systems work to leverage superior results
- What are the best functions to outsource measured by return on investment (ROI) and return on equity (ROE)?
- When is the right time? If not now, when? If not, why?

We'll examine these questions in more detail in this document.

BPO in The Early Stage High-Tech Company

For early stage technology organizations, business process outsourcing is often mandatory to get the business off the ground. Some of the fundamentals include:

- Paying Staff (Payroll processing)
- Health Insurance (Benefits administration)
- Product/Service Agreements (Legal services)
- Accounting functions (Financial services)

For most organizations, it simply doesn't make sense to bring these functions internally when external experts can handle the tasks more efficiently.

The challenge facing many high-tech organizations though is how to manage a fast growth path early in their life cycle. The "dot.com" era is a good example. The frenzy of recruiting staff; putting finance and administrative systems in place that scale with the organization's growth; and defining and building products

stress a management team. Should these systems best be built internally, or purchased as an outside service?

Answers to these questions are not clear. Executives of early stage companies should have the foresight to consider BPO to:

- Lower the cost of growth
- Improve their ability to compete
- Improve time to market
- Improve management systems

Questions the early stage company executive should ask include:

- Can I reach my growth goal more efficiently by using BPO more aggressively earlier in the life cycle of the company?
- How do I structure the management team to take advantage of what BPO can offer?
- Do I know my business transaction costs well enough to be able to price a BPO service contract effectively?

BPO in the Maturing High-Tech Company

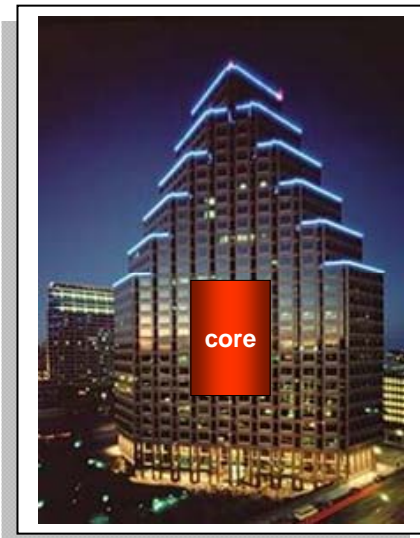
In the second stage of growth, the maturing high-tech organization presumably has a more established internal structure. The challenge often is how to optimize cost as expansion occurs.

This stage is important in the growth of an organization. This is the point where many of the internal systems are put in place – internal systems that support the operation and growth of the business. Defining the ‘operation of your business’ is in fact critical. Leaders of a maturing business must understand how to define the **core** of their business. The core is the part of the business that should never be outsourced.

While it may seem a simple thing to do, defining the true ‘core’ of a business during its maturing stage is not always easy. It can be tough to dissect the organization surgically to define what functions are core versus tangential.

For example, if you’re a B-to-B software company, what is the core of your business?

- Is it software logic you build or the intellectual property surrounding the software?
- Is it the distribution and support system?
- Should all software development occur at HQ, or should some or all be offshored?
- Should software maintenance activities occur at HQ, or can they be offshored?
- If customer support is 24x7, how and where should this be staffed? Domestically? Internationally? Both?
- Should consulting services be an internal group or should partners be trained to fulfill a percentage of implementations.



Defining the 'core' is not always obvious. There are a variety of ways to structure the organization. But, the ultimate question for a maturing company is where to draw the line of demarcation around the "core" of the business.

- Is the function strategic to running the business, or is it a commodity? If the function is strategic, it should not be outsourced.
- Is the function large enough to warrant outsourcing? If the function is too small, the company may not get enough leverage from the outsourcing relationship.
- Can the function be easily reproduced off site? If it is too unique, outsourcing may not work.
- Does the company have the data and information necessary to write an intelligent contract with measurable objectives? Is the company able to set metrics that are clear enough to help manage the outsourcing relationship?

Executives must think mid-to-long term and understand what business processes are essential, or core, to their operations. They need to compare the ROI/ROE to improve the business operation organically versus the cost of outsourcing

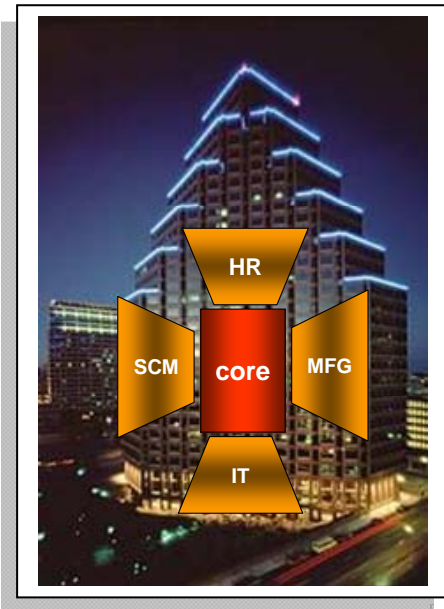
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The toughest challenge for most executives is to be **pragmatic** when analyzing such operational options. A pragmatic look at a business requires distancing oneself from the people and the systems already in place.

Think of it this way: an experienced high-tech executive could walk into another high-tech company and quickly determine what is core to that business. He/she could easily define which business processes are tangential and could be outsourced. He/she could also quickly reassemble the business using BPO as a foundation for non-core business operations. Objectivity is a wonderful thing.

Once the "core" of the business (in our case, technology) has been defined, we can layer on the appropriate functions to support the operation of the business. Most of these are defined as administrative functions -- we need to pay employees, provide benefits, create contracts, rent space, order furniture, market and sell the product, etc.

Another issue in brokering change is the potential impact of changing a high-tech organizations' personality (or brand). Since an organization's personality is often defined by the quality of people, especially technicians that work with customers and support the products. Changing certain customer facing functions such as Call Center or Help Desk can change the way customers and prospects view and interface with the company. This can be either positive or negative.



Questions the maturing high-tech company should ask are:

- What is the core of your high-tech business?
- What are your internal costs?
- What business processes are not core to the business?
- What business processes can be outsourced?
- How do I outsource key non-core functions while maintaining the brand identity of the core company?

BPO in The Mature High-Tech Company

The mature high-tech company has well formed internal business processes. The 'core' of the business is now well insulated in a variety of departments and procedures. Customers, for example, probably have well defined contact points and the overall relationship is complex (as measured by business processes). Purchasing has mature systems in place. Human Resources has standard policies and procedures.

Multi-location or multi-divisional organizations often use shared services – central services provided such disciplines as accounting, marketing, HR or manufacturing. Shared services are effective in cutting costs and standardizing large corporate functions. The option to outsource these functions has probably been explored in detail simply because the large BPO organizations are selling their services to these organizations. Awareness drives interest.

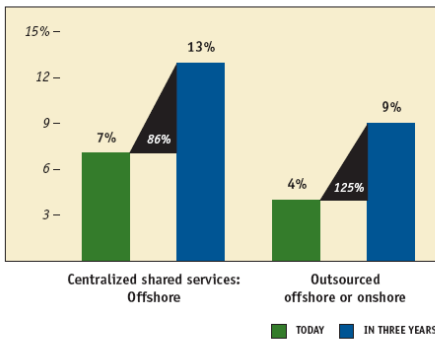
Measuring the financial impact of BPO for a mature organization is easier since there is more information available.

- Large BPO vendors have tracked their results for previous customers.
- The mature organization has better tracking systems internally and therefore has a better understanding of the costs of doing business.
- Experienced management teams know how BPO can impact the performance of the organization.

Mature high-tech organization must ask similar questions as the 'maturing' organization with regards to BPO.

- What is the core of my business?
- Can I improve margins while enhancing the corporate brand?
- Can I reduce the risks inherent in growth?
- Can I improve or enhance corporate flexibility?
- Should I change my shared services to an outsourced environment?
- Should I centralize on a global basis, or on a regional basis?

Trends in sourcing strategies, 2005



Source: ©2006 The Hackett Group

Defining the Economics of BPO

Business Process Outsourcing is clearly a paradigm shift in the way business operates, or could operate. While outsourcing is an age old practice, the advent of the current BPO revolution has been driven by the availability of cost effective technology such as the Internet, broadband communications, inexpensive data storage, online analytical processing tools and continued business process specialization.

The 'shift' then is that technology has enabled a global exchange of business processes. The BPO industry has matured to the extent that costs are normalizing and becoming more attractive.

Are the results worth the investment? According to an analysis completed by NelsonHall, a BPO analyst firm, the results are positive:

- 80% of companies claim that outsourcing has increased their competitiveness
- 87% of companies say that outsourcing services have helped in improving the quality of their internal processes
- 77% of companies say they could see a significant drop in their process cost by outsourcing

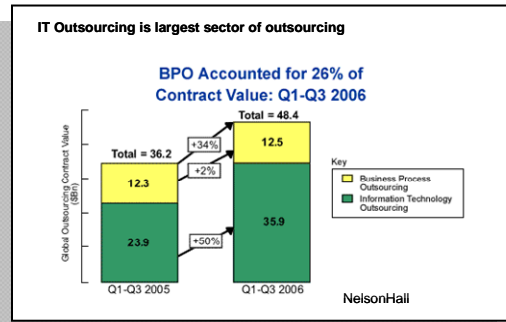
While NelsonHall and other organizations track the status of BPO contracts around the world, data on the individual performance of these contracts is generally not available. So, providing comprehensive information on the economic benefits of BPO is not always easy.

From the three growth categories discussed above, the stages most currently influenced by BPO are probably the 'early' and 'mature' stage organizations. The 'maturing' stage might be considered the least likely to take advantage of BPO simply because they are not large enough to attract the large BPO vendors. In many ways, though, this is the growth category that should be looking at the advantages of BPO most aggressively.

BPO vendors serving the mid-market range across all business process segments and are growing, quickly. In fact, many vendors see this as the next large growth segment.

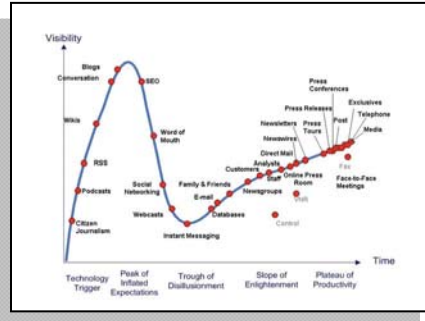
The Hype Cycle: Hot BPO Areas

Industry analyst Gartner Group has developed an industry tracking category called the Hype Cycle. The Hype Cycle is a representation of the maturity, adoption and business application of specific technologies. The term 'Hype Cycle' is derived from vendors' promotional hype in promoting new products and services. Based on research conducted by Gartner Group, there



are about 25 categories of BPO being tracked as riding the Hype Cycle.

The following table highlights Gartner's view of the BPO disciplines currently moving through the Hype Cycle. The business processes listed in the right column are classified based on Gartner's view of their general acceptance in the market. If a BPO function approaches the 'plateau,' it is considered highly accepted by the market. IT outsourcing for example is considered an established discipline.



Gartner: Sample Hype Cycle diagram shows growth cycle, trough and plateau.

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Gartner Hype Cycle Category	Business Process
Technology Trigger	
- High growth potential	Knowledge Process
	Core Banking
	Direct Procurement BPO
	Payment Service BPO
	Insurance Closed Book BPO
	Multi-Function CRM BPO
Peak of Inflated Expectations	Comprehensive Finance and Accounting
	Accounts Receivable BPO
	Revenue Cycle Management
Trough of Disillusionment	
- Early growth stage met	Comprehensive HR BPO
	Mortgage Origination
	Accounts Receivable BPO
	Payment Services BPO
	Global Contact Center
Slope of Enlightenment	
- Early interest wearing off	Billing BPO for Telecom
	Tele-Radiology
Plateau of Productivity	
- Becoming standard practice	Contact Center BPO
	Payroll Outsourcing
	Benefits Administration
	Transaction Print Services
	Billing BPO
IT Outsourcing	
- Commonly accepted practice	Telesales/Telemarketing
	Credit Card Processing

IT Outsourcing
 Since IT is one of the largest BPO disciplines, there has been more research on ROI/ROE measurements than most other BPO areas.

Paul A. Strassmann is a highly regarded BPO analyst who has extensive experience in managing IT operations and measuring the impact that outsourcing can have on an organization.

In a recent article for Baseline Magazine, he presented a formula that IT executive can use to determine what percentage of revenues typical outsourcing activities should be. He examined how much of a company's resources are devoted to managing its information versus producing and delivering goods and services?

"I have devised a model called the Information Management Multiplier (IMM) to identify the scope of information activities at a company," said Strassmann. "To start, take sales, general and administrative costs, as reported on financial statements. I exclude research and development because it is usually outside a CIO's oversight. Next, take the net cost of operations, which are total operating costs minus the worth of all outsourced work.

"The ratio of information management to net cost of operations then becomes the IMM, which reveals how much information management costs exceed (or don't exceed) the direct costs of production and services," explains Strassmann.

In another article appearing in Information Economics Journal, Strassmann defined 'value-add' as the way corporations create wealth, or profit. Subtracting value added from revenue yields the worth of purchases (e.g. inputs outsourced to others).

In this article Strassmann notes: "Neither the size of the firm nor the sector in which it operates will determine the outsourcing ratio. The extent to which a firm outsources reflects its unique characteristics and is not an inherent reflection of its market position, profits, capital structure, employment skills or competitive position."

Are BPO return on investment figures always good? Not always. In a study conducted by Strassmann, he compared the Outsourcing Ratios for 1,110 firms based on the highest and lowest ranked firms in return on shareholder equity.

Cheaper, But Not Better		OUTSOURCED WORK as a percentage of sales	
Comparison of Outsourcing Ratios for 1,100 Firms		Median ratio for high-ranking half	Median ratio for low-ranking half
Top-ranked 277 firms by return on shareholder equity (median ROE = 18.0%)		49.1%	54.6%
Bottom-ranked 277 firms by return on shareholder equity (median ROE = minus 55.4%)		71.1%	83.2%

Strassman, Inc.

Strassmann reports: *“The winners and losers per se were ranked according to their outsourcing ratios. The higher-ranking half of the 277 winners outsourced a median value of 49.1% of sales. The bottom-ranking half of the losers outsourced 83.2% of sales.*

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The statistics suggest that outsourcing does not appear to follow a standard assumption that increasing purchases (outsourced services in this case) indefinitely in search of the cheapest source of supply does not seem to deliver profitability, as measured by the return generated on shareholders' investments in their companies.

The study indicates that when measured by shareholder equity, those firms with the lowest ROE tend to have higher outsourcing/revenue ratios than those in the top-ranked firms. Strassmann did conclude that “outsourcing is essential for the growth of any economy. Whether outsourcing is economically effective depends on the organization of the value-chain.”

Do these findings suggest an inexplicable contradiction—a paradox—that runs counter to widely believed ideas about the benefits of outsourcing for gaining the lowest costs?

Probably not. The costs of making the purchases of lowest-cost product and services may explain the difference. A purchase makes sense only if the transaction costs are lower than the difference in the costs of purchasing something compared with doing it in-house.

The conclusion: Either the costs of purchasing outside work are too high for the "losers"—that is, they don't manage their purchases well—or their businesses have inherent flaws.

Flaws that cannot be cured by shifting work to others.

Strassmann summarizes as follows:

- Outsourcing is the distribution of labor and knowledge through specialization
- Gains exist from increases in Value-Add (Profit)
- Losses exist from divestment of Knowledge

Keep in mind that this is one point of reference and for high-tech firms in Georgia is not necessarily a key indicator of BPO results.

BPO Performance Metrics

Executives often look at BPO from two perspectives: cost reduction and strategic business process improvement.

In the “Essentials of Business Process Outsourcing” Thomas Duening and Rick Click identify the metrics that best define each category.

Cost reduction BPO:

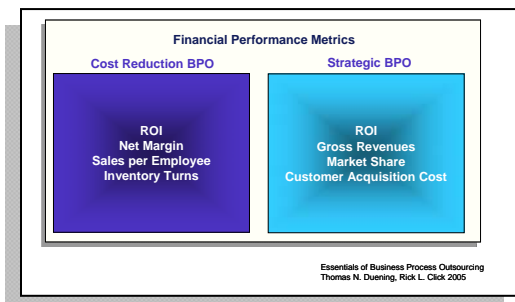
- Return on Investment (ROI)
- Net Margin
- Sales per Employee
- Inventory Turns

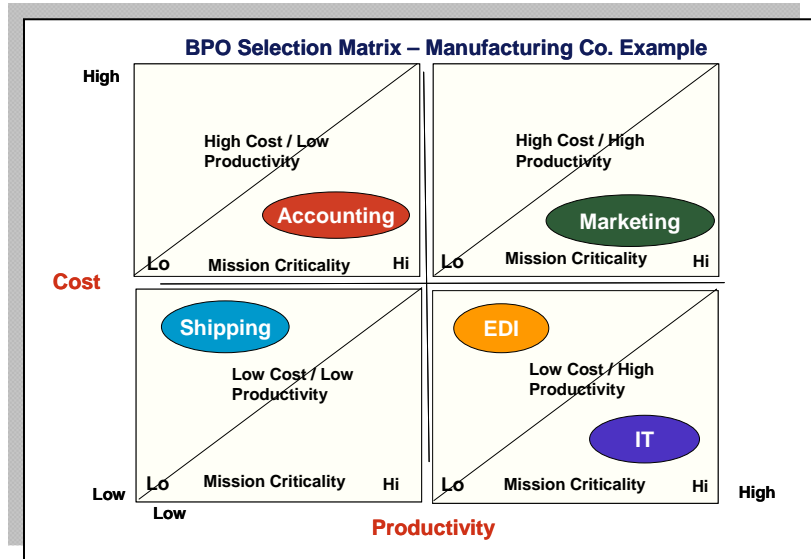
Strategic BPO

- Return on Investment (ROI)
- Gross Revenues
- Market Share
- Customer Acquisition Cost

Balancing the strategic versus operational cost reduction needs requires understanding the core of the business and adding a strong dose of pragmatism. In this book, the authors examine a hypothetical manufacturing company using a BPO Selection Matrix to determine where BPO value can be achieved. See chart below.

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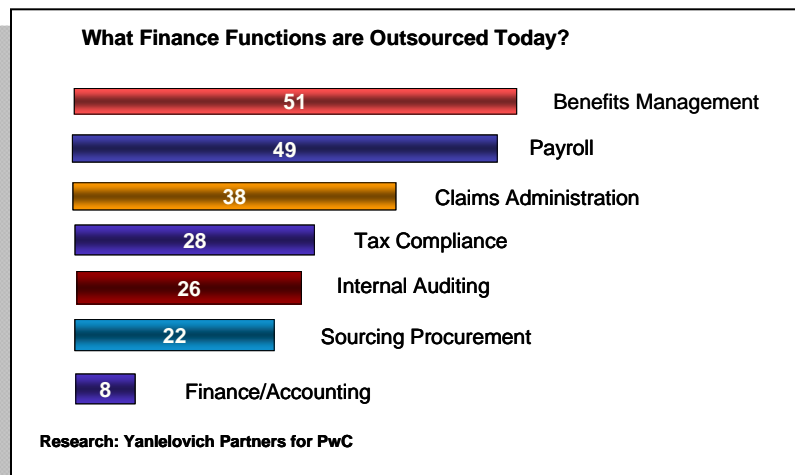
This chart highlights the following:

- IT is a mission critical function that delivers high productivity at a relatively low cost
- Accounting is a mission critical function that has high costs but generally typified by low productivity
- IT, Marketing and Accounting could demonstrate the highest strategic yield in outsourcing

BPO Metrics – Drill Down in Finance and Administration

According to Yanlelovich Partners in research conducted for PwC, BPO for finance functions represents 9% of the total outsourcing market in the U.S. and is growth at 11% annually.

The graph below shows the finance functions most commonly outsourced.



Accounts Payable example: The Hackett Group published statistics showing the promise that the Accounts Payable function has as a BPO candidate:

- Enterprises that outsource reported cost savings approaching 10% for all invoice processing
- 20% of enterprises currently outsource some part of the A/P operations
- Another 15% intend to outsource in the near term

In an article ***Shifting Sands: Focusing Finance in the 21st Century***, the authors wrote:

“Over the past 15 years, finance has embarked on a much needed turnaround from being unresponsive bean counters processing lower value transactions and enforcing controls. Dissatisfied with being seen as expensive overhead, finance laid ambitious plans to operate more efficiently, refocus on higher value added activities, and contribute as a true business partner.

That vision has only been partially realized. True, costs have declined and productivity has improved. In 1990, finance cost the typical company 2.2 percent of annual revenues; today that cost has been dropped to 0.75 percent – a 66 percent reduction.

Finance should not be in the business of transaction processing or management reporting in the 21st century. Instead, it should be focusing exclusively on the shifting sands of organizational survival.”

The same holds true for other knowledge worker functions like HR, procurement, and IT.

The authors strongly encourage financial executives to get out of the process improvement model, initiate the outsourcing of all transaction processing and administrative work and focus on identifying the signs of market complacency, competitive challenges and building market share.

This is highly relevant for the growing high-tech companies that, by definition, need to focus on the constantly shifting sands of the market. In no market, is it so prevalent that product life cycles compress faster than any other market.

The Hackett Group notes in a research report: “An often asked question is whether Finance is purely a cost-driven solution. The resounding answer is no. Finance is not just about labor arbitrage; it is also about improving quality. Among the capabilities increasing offered by many providers is strength in compliance management and management reporting – both top-of-mind issues for CFOs and CEOs. Additionally, Finance providers’ ability to leverage technology and advanced analytical

tools can instantly provide capabilities that otherwise would take significant time and capital to develop internally.” (“116 Million Reasons Why The World is Flat,” Hackett Book of Numbers Insight).

The Future of the Organization – with BPO as the Foundation

Once again, the reason that BPO has grown so dramatically over the past 10 years is the availability of the technology infrastructure required to drive this global initiative. Without the Internet or availability of broadband services, this phenomenon could not have been possible.

Assuming the technology infrastructure continues to break down the barriers of global communications, where could this all lead? What should technology companies expect and plan for?

Considering the progress made over the last ten years in standardizing and automating business processes, the next ten years promise similar advances. Typical of most markets, the largest companies define market trends and the acceptance of new products/services. Once established, competition and availability drive costs down making these new products/services readily available to small and midsize organizations.

If we separate ourselves from the conventions of business practices commonly used and accepted today, business could take on a new shape over the next ten years.

In all probability, the following will be prevalent:

- Common business processes will continue to standardize
- Technology platforms supporting these processes will standardize – especially in the software arena
- The cost of BPO will standardize at the transaction level and be driven by volume as world markets embrace the business practices
- Organizations will gain competitive advantages earlier in their life cycle through the effective use of BPO
- The definition of an organization’s core business will be refined and narrowed as executives tune their market and delivery strategies

The BPO Balance

The Hackett Group provides a useful summary of the key factors that must be analyzed in determining your outsourcing options.

The chart below outlines the three primary categories:

- Process Complexity
- Risk Tolerance
- Net Present Value (NPV)

Top elements to be examined for each of the three key components

Process Complexity	Risk Tolerance	Net Present Value (NPV)
<ul style="list-style-type: none"> • Time to learn process to average proficiency • Degree of centralization for current process • Current technology implementation • Industry context requirements 	<ul style="list-style-type: none"> • Management's global operations experience • Organization's cultural aversion to risk • Potential impact on critical business functions • Client intimacy requirements • Cost of service disruption 	<ul style="list-style-type: none"> • Initial discovery investment • Implementation investments • Ongoing costs / savings • Potential risks / upsides • Relative rates of (wage) inflation

Source: The Hackett Group, 2007

Summary and Takeaways

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Business Process Outsourcing is not for everyone. But, there is no question that it can help organizations reduce costs and improve operations.

For high-tech executives, we encourage the following:

- Understand clearly what the **core** of your business really is and stick to that core.
- Keep your knowledge (product, market, process) close to the core of the organization.
- Consider outsourcing what is non-strategic, non-core to the business.
- Be **pragmatic** when determining the best course of action in outsourcing functions.
- Know your costs – the more you understand the cost of doing business (at the transaction level), the more competently you can analyze the potential benefits of BPO.
- BPO is practical and available for the midsize organization whether for early stage, maturing or mature organizations.
- Look for BPO to add value, not just reduce costs.
- A BPO relationship is strategic and should be managed in this way.
- Use industry measurement formulas where possible to define the impact that BPO can have on your organization.
- Remember that outsourcing is not a panacea. Good management principles and disciplines always apply.

