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Editorial Contact: McKinsey_on_Finance@McKinsey.com

Editorial Board: James Ahn, Richard Dobbs, Marc Goedhart, Bill Javetski, Timothy Koller, Robert McNish, Dennis Swinford
Editor: Dennis Swinford
Design and Layout: Kim Bartko
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Outsourcing grows up

Many outsourcing deals are tantamount to strategic divestitures and joint ventures. Executives should start treating them that way.

David Craig and Paul Willmott

When companies first started thinking about farming out nonstrategic functions—such as payroll, IT maintenance, facilities management, and logistics—their goal was to reduce costs. Today, however, these corporations regularly contemplate outsourcing core operations to third-party specialists in order to improve operational performance. Many such deals are big and strategic enough to qualify as "bet the company" arrangements involving a complex mix of people, processes, and assets. Indeed, almost 100 megadeals (contracts with values of greater than $1 billion) have taken place in the past ten years, with 15 in 2003 alone.[1]

Yet few companies have changed the way they make deals. Our research[2] found that most corporations still rely on a standard procurement approach, with contracts and agreements managed by individual departments—the way they make commodity purchases. This mind-set is underscored by the increasing use of third-party consultancies, which often reduce the bidding process to a commodity comparison of vendors that limits transparency and that uses price as the primary decision-making factor. Neither customers nor vendors are served well: the process limits ways to improve the economic value of a deal for both sides and creates large, unnecessary risks that vendors are expected to bear.

Not surprisingly, up to 50 percent of outsourcing arrangements fail to deliver the expected value (Exhibit 1). Poorly planned deals often have some of the same shortcomings as flawed divestitures and joint ventures: companies overestimate the economic benefits of the deal, fail to establish the right baseline for price negotiations and performance tracking, or are not fully prepared to manage the transition and postdeal situation. And outsourcing has some unique challenges as well. Companies sometimes accept a vendor's riskiest goals, establish strictures that reduce the vendor's ability to manage costs effectively, or put so much emphasis on getting rock-bottom prices that they lose essential performance guarantees and flexibility.

Given the size, the degree of complexity, and the importance of outsourcing deals to a company's overall portfolio strategy, we think senior executives would be wise to apply the same rigorous approach to these agreements as they would for mergers, divestitures, and joint ventures. Both the

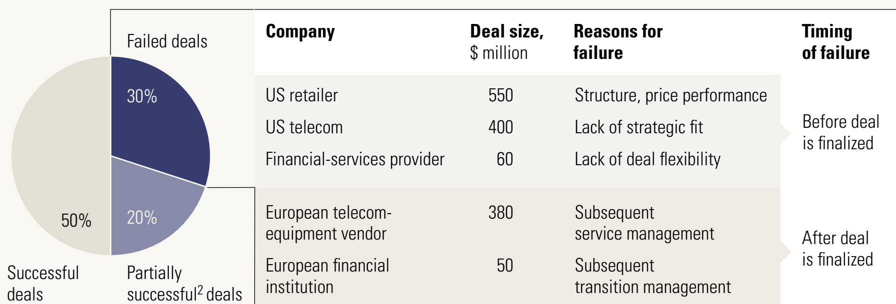
[1] Gartner.

[2] We studied 30 outsourcing deals, signed in the past four years and worth more than $20 billion in total contract value.

EXHIBIT 1

Around half of all deals come up short

Outsourcing-deal success rate[1]



Company	Deal size, $ million	Reasons for failure	Timing of failure
US retailer	550	Structure, price performance	Before deal is finalized
US telecom	400	Lack of strategic fit	
Financial-services provider	60	Lack of deal flexibility	
European telecom-equipment vendor	380	Subsequent service management	After deal is finalized
European financial institution	50	Subsequent transition management	

[1] For 30 outsourcing deals signed within past 4 years and worth >$20 billion in total contract value.
[2] Deals did not deliver planned benefits and/or were subsequently reduced in scope after problems with suppliers/customers arose.

customer and the vendor must find the relationship valuable over the longer term.

Applying M&A principles

When outsourcing deals were smaller and limited to noncore processes, executives could treat the transactions as fairly standardized, the strategic implications as limited, and the risks as well understood. Today, the executive team no longer has the luxury of easy decision making, and not merely because the average size of deals has grown. How a company develops its outsourcing relationships directly affects its core strategic planning: the shape and boundaries of its corporate portfolio and the focus of its executives. Some guidelines can increase the odds of outsourcing success.

Clarify deal strategy from the beginning

The strategic objective of an outsourcing deal must be explicit from the outset. The goal of some deals is simply to have a low-value job done more cheaply, to make the cost base more variable, or to leverage a provider's skills, expertise, technology, or processes. Many of today's arrangements go further, aspiring to improve operational performance and service levels or to free managers to focus on higher-value-added activities.

Once the objective of the deal is clear, the best way to structure it becomes clearer too. It often makes sense to go far beyond a traditional procurement-type contract. If the outsourced function or process is noncore, for example, and if cost cutting is the primary goal, then often an outright divestiture makes sense. Many of today's formalized outsourcing arrangements are effectively divestitures, even if managers don't think of them that way. Such arrangements transfer assets—including people, systems, intellectual property, and even buildings—to a vendor and create obstacles to bringing them back in-house. Companies also cede management control to vendors, since the contract governs the formal relationship. Unfortunately, most managers still think about their outsourcing contracts as if they can recover all their assets at the end of a deal. In fact, while many outsourcing agreements include provisions for the return of assets, the vendor often retains access to intellectual property and has already reassigned its best people to other contracts. As with any divestiture, companies should consider such a move only if the loss of flexibility won't hurt business performance.

One financial-services institution learned this lesson the hard way when it structured the outsourcing of its lending operations as a divestiture. The company relinquished control of its people and IT systems in return for guaranteed service but lost the flexibility to support new products. The managers who structured the deal had focused primarily on cost cutting without considering this crucial component. They discovered the flaw when the institution was unable to offer new forms of lending: it was precluded by contract from developing the product, and the vendor was unable to develop it.

On the other hand, if the goal is to improve the performance of a strategically important function or process, then managers should consider structuring the deal like a joint venture. Under this type of arrangement, both companies share ownership and control of assets, splitting the costs of new applications, technologies, and operating improvements. An approach that incorporates the best features of a joint venture—without necessarily creating one—can help align incentives for both parties to make the deal work and to create economic value. Specifically, it rewards the vendor's successes while allowing the buyer to retain flexibility and control.

One European company structured an outsourcing agreement as both a divestiture and a joint venture. It transferred ownership and control of its desktop and network IT assets to the vendor but shared a core-application platform critical for addressing changes in the marketplace. One year later, both companies are working together to improve the effectiveness of the applications and reduce costs. Meanwhile, the vendor has freed the company's management from the time-consuming task of redesigning and improving the desktop platform and network.

Assemble the right team

Companies typically rely on teams with a heavy concentration of IT managers to execute and oversee outsourcing relationships. Historically, IT functions were early targets for outsourcing, so these managers developed expertise in this area. Today's complex arrangements, however, require a deal-making team with a wide range of skills that go well beyond those of most IT experts.

Innacurate estimates of the total value of an agreement lead to incorrect revenue distribution between the buyer and the vendor.

As in any M&A deal, at least one team member should focus on the economics of the deal. In addition to handling the typical merger questions, this individual should be fluent in the process to be outsourced as well as the vendor's economics. We find that often companies accept a vendor's target prices or risky promises at face value. Other team members should be able to draw on that knowledge to determine appropriate service levels and transition plans and to manage supply and demand.

Such detailed knowledge is critical, since a key component of negotiating for shared value is setting the right baseline—the basic level of vendor support and its current cost. A pricing expert, organizational-change specialists, and experienced negotiators should also be included on the team. One company that sent its development of IT applications to India assembled a team of five technology experts and three human resources (HR) managers, along with representatives from each business unit, third-party consultants who understood offshore economics, and specialists in M&A, law, and tax. The team, led by the CIO, reported biweekly to the global executive committee. Over the course of its eight-month tenure, the team structured the scope and incentives of the deal, planned the transition, managed the economics, and selected and negotiated with the suppliers.

While the use of a third-party consultant can be beneficial to both sides in an outsourcing negotiation, its role often deteriorates into commodity procurement—to the detriment of customer and vendor alike. These firms usually position themselves as intermediaries, often precluding any direct contact between the customer and the vendor. As a result, negotiations become exercises in adherence to a proposal written without the creative input and experience of vendors. Furthermore, third-party consultants often discourage customers from discussing any alternative proposals from vendors, even if this step is in the interest of both companies.

Focus on value, not cost

Many companies with traditional outsourcing agreements have focused only on the embedded value of an agreement—the cost savings realized by the buyer or the new revenue streams created by the vendor. As a result, inaccurate estimates of the total value lead to incorrect revenue distribution between the buyer and the vendor or undermine the deal altogether. One financial-services company, for example, hoped to transform its

EXHIBIT 2

Shared value in negotiation

Typical M&A deal structure	Contribution to total deal value	
	Buyer	Supplier
Embedded value	• Provides assets (people, systems) and business volume over contract lifetime • Bears cost of setting up, managing contract	• Introduces new efficiencies, cost-structure benefits • Improves buyer's service levels/control, reduces buyer's management overhead, and thereby improves buyer's balance sheet • Reduces buyer's delivery risk
Option value	• Provides supplier with skills, capabilities to attract new customers • Contributes to cheaper service platform for new supplier's subsequent clients	• Gives buyer ability to absorb higher volumes, create new products, or make acquisitions
Liabilities	• N/A	• Bears transition risk • Reduces (or increases) buyer's operational risk
Exit cost	• Carries cost of transferring operations elsewhere or bringing them back in-house	• Carries cost of losing buyer's business

Typical deal focus

customer-service and back-office functions by outsourcing the development and operation of its new customer-service platform. The company spent three months negotiating solely on price, and while it ultimately got the lower price it had sought, it did so at a considerable cost: the supplier no longer guaranteed performance, shared the operating risk, or contributed staff. The deal changed from a partnership focused on business improvement to simple software procurement.

A more complete examination of the sources of value—a key principle of smart M&A—can help an executive team set a realistic and fair target price. Many outsourcing agreements also generate value through options including new business opportunities, such as the vendor's resale of deal-related software or the buyer's offering of new products to new markets. Other teams create value by changing the liability and risks their company faces.

The key is to consider all the components of value, along with the risks (Exhibit 2). What is valuable to the buyer may cost the vendor, and vice versa. Higher service levels can typically increase the vendor's cost base by requiring more resources, for example.

Similarly, retaining architectural control may feel more comfortable to the customer, but doing so eliminates one of the primary sources of value creation in an IT infrastructure: the centralization, consolidation, and standardization of applications and hardware. Even though a vendor may try to protect itself by extracting promises from customers to perform some of these transformations themselves, it often has little recourse if customers don't follow through.

Create transparency

Increasingly, the initial proposal is used as the baseline for the asset and labor pool that the outsourcer will handle, and vendors are not permitted to conduct their own due diligence before signing the deal. Furthermore, in many cases the contracts don't even contain the ability to verify the deal's assumptions—and thereby the price. This arrangement creates significant and unnecessary risks for vendors, since the structure and cost of a technical solution are critical to the amount and level of services a vendor must provide.

In extreme cases, the denial of due diligence is combined with a so-called sweep clause, which requires a vendor to assume all physical assets, labor resources, and services formerly provided by the customer's IT department—even if they were not included in the initial proposal or even in the contract's statement of work. Omissions in the proposal's baseline are often one-sided, however, since customers often are

EXHIBIT 3

Safeguarding the deal

Safeguard	Outsourcing approach	Examples
Earn-out: Links final acquisition price to future earnings	• Supplier fees linked to business volume • Bonus/penalty clauses linked to business performance	• Volume boundary for price is created (eg, 10–20% volume increase results in 5% price increase) • Bonus is awarded only if customer experience in call center improves • Repeated failure to meet agreed-upon service levels triggers termination clause
Representation, warranty: Links acquisition prices to original scope, assets, service-level assumptions	• Price reviews occur at predetermined times; price-review approach predetermined	• Contract renegotiation is triggered by periodic benchmarking • Mechanism is established to alter prices if inaccurate asset register is used during due diligence
3rd-party arbitration: Establishes neutral party to arbitrate conflicts	• Neutral auditors, consultants, other suppliers ensure price/service competitiveness	• Supplier and buyer name 3rd-party auditor to assess deal performance
Control change: Grants parties right to pull out of deal should ownership change hands	• Buyer and supplier have right to terminate contract should ownership change hands or key personnel leave	• Acquisition by 3rd party of supplier's organization triggers termination clause • Buyer holds veto power over supplier's appointment of key staff

not aware of their total existing assets, resources, or services. The resulting risks for vendors can be massive, potentially turning a seemingly attractive deal into a losing one.

Manage the risks

No matter how well structured a deal is, conditions can change to upset the value equation. These factors include management turnover, poor service delivery, major increases or decreases in business volume, and corporate activity such as mergers or acquisitions. M&A practitioners have devised a number of safeguards that companies can apply to outsourcing deals to protect their interests (Exhibit 3). These measures include earn-outs, which ensure that prices reflect fluctuations in the business environment; warranties and other mechanisms that periodically realign price and service levels; third-party arbitration to ensure a quick and fair resolution of any conflict; protection against unfavorable changes in management or key personnel; and exit clauses.

The aim of these safeguards is to protect both parties in an outsourcing deal from unforeseen or unfortunate developments. One vendor found inaccuracies in staff compensation and asset levels when it took over the IT-management function for a new customer. The problem was amicably resolved with a clause in the agreement that allowed for a price increase.

When ending a vendor relationship, the key is to manage exit and transfer costs. A company can accomplish this task by transferring only those skills or capabilities that can be easily returned, thereby ensuring that a vendor uses open, standard processes and equipment. In cases when this exchange isn't possible, the agreement should obligate the vendor to provide training for the buyer's staff alongside its own. One UK financial institution, for example, transferred all the intellectual property from the design of its trading systems to the provider. At the end of the contract, the company had to spend 12 months rehiring and training staff to lower its switching costs. In another case, a company protected itself with a clause that covered the cost of exit if the vendor's service declined to unacceptable levels.

Negotiate internally, then externally

A successful outsourcing deal involves both internal and external negotiations, which are often more complex than M&A talks, in part because many more internal stakeholders are involved. Outsourcing deals need approval from not only the board and executive team but also managers in operations, financial controllers, and technology experts. What's more, there is no standard protocol for appraising outsourcing deals, so it can be

difficult to gain consensus on their value and strategic implications. Last, suppliers frequently offer such a wide array of scope, service levels, and pricing options that comparing deals is difficult.

As a result, negotiating teams must work internally with the business managers who control the process to be outsourced, with employees and union representatives who will be affected by the move, and with the executive team. Internal stakeholders should agree on service levels, the degree of flexibility, the controls that the team will secure from a vendor, and acceptable transfer conditions (and their implications for staffing levels). Without alignment on these critical issues, the effective handoff of processes to external vendors will be difficult. The negotiating team must also agree with executives on pricing as well as compare the value of the deal against the next-best alternative, which is typically an internal-improvement plan.

These interactions within the company pave the way for successful vendor negotiations, in which services, procedures, assets, and total value are hammered out, along with pricing and the other mechanisms for sharing value.

The bargaining process is most effective when it is driven by a stand-alone negotiating team—one that is separate from the overall deal team and excludes the head of operations or the business managers who run the process to be outsourced. Operations managers tend to focus on liabilities and service and commitment levels instead of keeping in mind the total value of the deal. The head of operations at one company went forward with an outsourcing agreement without first consulting the executive team, which ultimately rejected the deal because they didn't fully understand its economics. The company had to start from scratch, which delayed the deal by six months—a time marked by major internal confusion and uncertainty among employees.

Plan for transition and delivery

As M&A practitioners know, effective post-deal management can mean the difference between success and failure. Yet this aspect of outsourcing is often given short shrift as the deal team becomes focused on the near-term objectives of evaluating and negotiating the deal. Before signing a contract, a company and its outsourcing vendor must clearly structure the new management organization, define the roles and responsibilities of each party, design and install reporting and control mechanisms, and plan hiring for new roles.

Uncertainty during an outsourcing transition also increases the risk of staff turnover, so companies should design a retention program that targets and retains key personnel. One hotel chain was able to keep its best employees by setting up performance-based bonuses for staying on through the transition. In another case, the vendor held one-on-one sessions with more than 100 employees of the customer company to articulate the value of staying with the new organization.

Outsourcing deals have become bigger, more complex, and more strategically important. By applying M&A deal principles rigorously, executives can avoid costly errors. MoF

David Craig (David_Craig@McKinsey.com) and **Paul Willmott** (Paul_Willmott@McKinsey.com) are partners in McKinsey's London office. Copyright © 2005 McKinsey & Company. All rights reserved.

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