ISRC Notes—March 2003

"Revitalizing Back Office Functions through Enterprise Partnerships"

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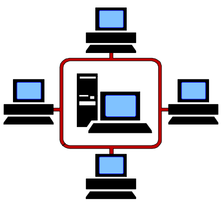
Based on a presentation by Mary Lacity, University Missouri-St. Louis

In March, ISRC welcomed University of Houston alumni Mary Lacity to discuss emerging trends in outsourcing. She covered both ends of the spectrum, beginning with smaller companies use of application service providers to access best of breed software, to larger organizations seeking radical improvements in back office functions by forming enterprise partnerships with vendors to handle the assets, infrastructure, and people supporting internal business processes. The research findings are based on her work with Leslie Willcocks, David Feeny, and Thomas Kern.

Application Service Provision: One-to-Many



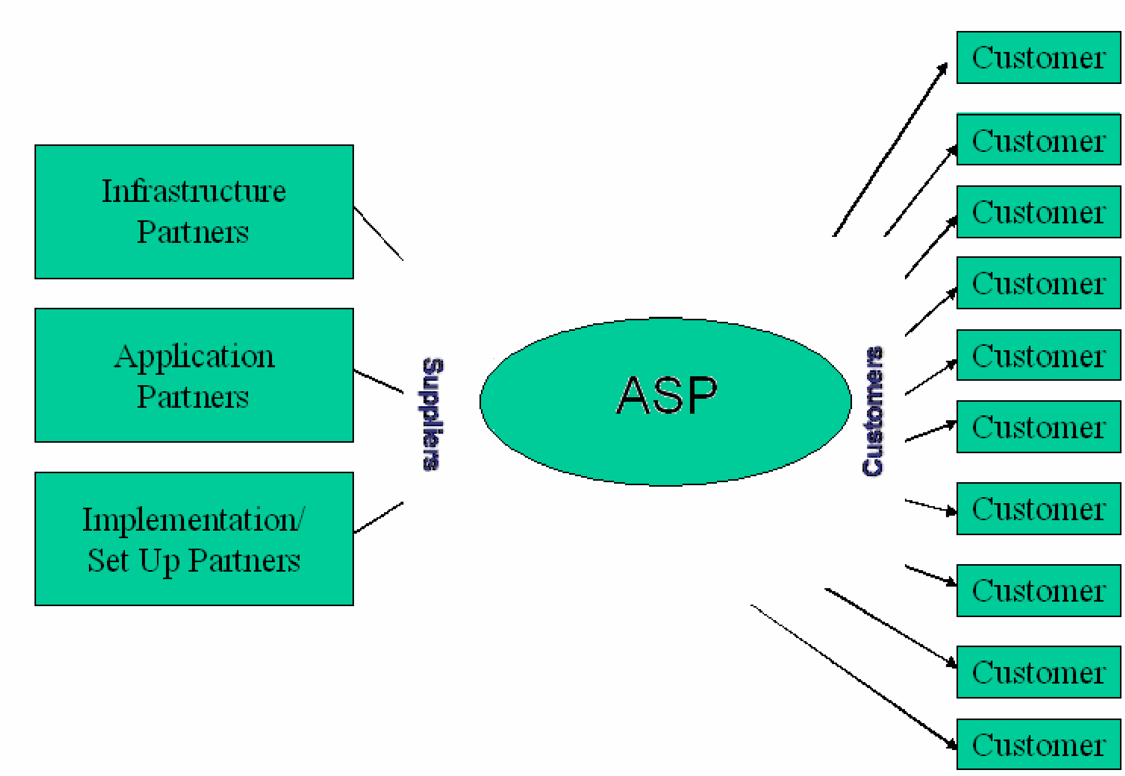
Application service provision is *the practice of renting or "paying as you use" access to centrally managed business applications, made available to multiple users from a shared facility over the Internet of other networks via browser-enabled devices.* ASP allows customers to receive business applications as a service. The ASP to customer relationship is one-to-many, meaning that one ASP would provide similar services to many companies. Through this arrangement, ASPs have promised to deliver an array of benefits to customers, including:

- 30% to 50% reduction in Total Cost of Ownership
- Superior cash flows
- Access to best-of-breed innovations
- Flexible, scalable solutions
- Rapid implementation

The current estimations for the ASP market ranges from $1.9 billion (Forrester Research) to $3.6 billion (Dataquest). Within the next few years, however, a significant growth is expected in this area with projections for 2004 ranging from $7.8 billion (International Data Corporation) to $25 billion (Dataquest). Forrester Research also shows that the ASP model appeals more to small to medium size enterprises.

All figures in $US Millions	1999	2000	2001	2002	2003
< 100 employees	316	649	1,233	2,257	3,850
100 to 999 employees	562	1,188	2,304	4,090	6,623
Over 1,000 employees	55	127	266	498	838
Total	***933***	***1,964***	***3,802***	***6,846***	***11,311***

With the expanding needs of customers, ASPs have evolved into more of an intermediary role, providing a wide range of services to customers through relationships with various vendors. In this scenario, the ASP acts as the intermediary between customer and vendors, bringing each together to meet specific customer needs.

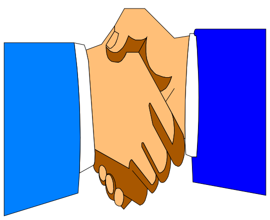


This model has proven popular because it allows a company to deal with one ASP, yet get services from a variety of specialized vendors that can best meet the needs of the business. Services most commonly delivered through this type of arrangement include email &

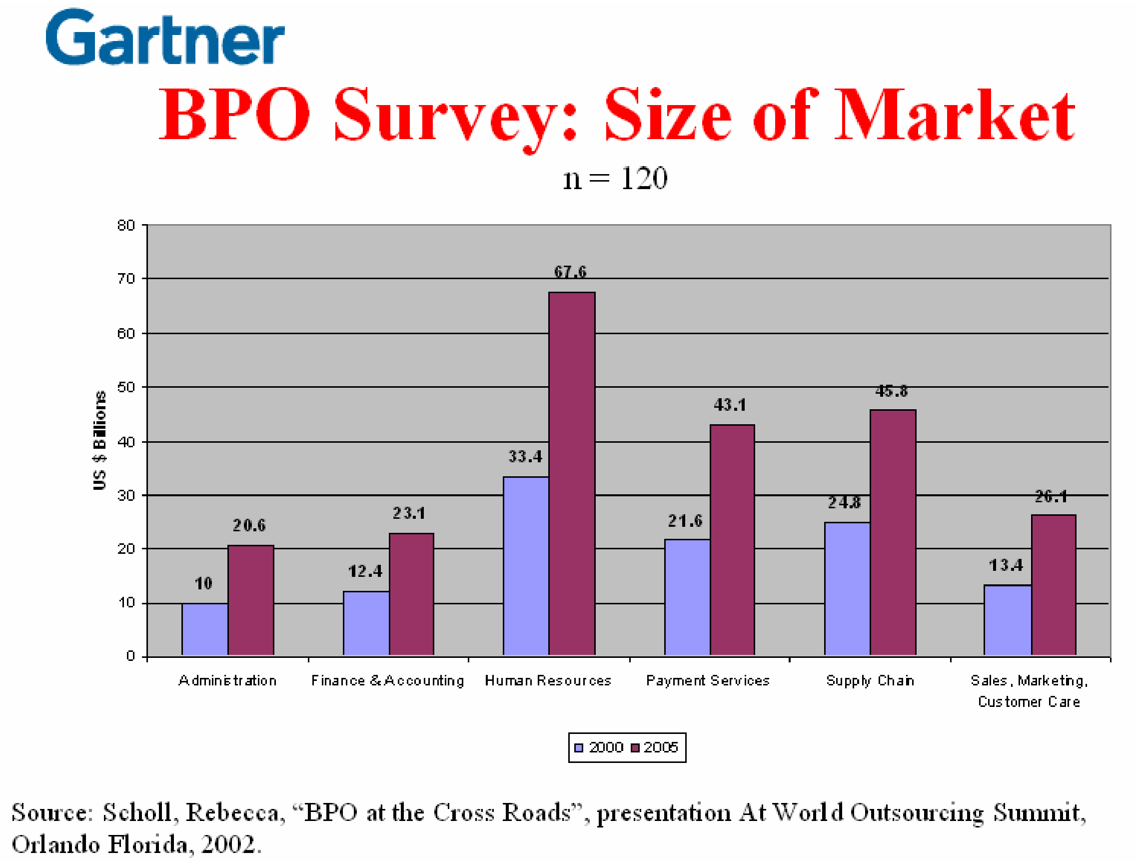
communications, personal productivity, finance & accounting, CRM, HRM, B2B, B2C, and ERP.

Even though the ASP market is growing rapidly, ASP companies are struggling, making many organizations leery of outsourcing critical business processes to companies that are having financial difficulties. In spite of the financial difficulties, outsourcing continues to evolve.

Business Process Outsourcing: One-to-One



In stark contrast to the ASP model, the BPO model entails a close relationship between the customer and supplier. Rather than just outsourcing the information technology associated with a business process, BPO customers outsource the entire business process to a supplier, including infrastructure, applications, and people. BPO has become one of the fastest growing segments of the outsourcing market. Input, Inc. estimates that BPO will assume one quarter of the outsourcing market by the end of 2003.



While BPO is a logical extension of IT outsourcing, customers must incorporate the planning and learning acquired through prior IT outsourcing experiences. BPO will likely require more attention to decision making, supplier selection, contract negotiation, and relationship management.

The success of BPO has led to a further evolution of outsourcing…enterprise partnerships.

Enterprise Partnerships: One-to- Many

Larger companies that are looking for BPO are starting to take outsourcing to a new level. By forming enterprise partnerships with a supplier, the organizations have a vested interest in the relationship. These enterprise relationships allow for the transfer of employees from the primary organization to the newly formed enterprise. Thus, the organization will have many of the same employees doing the same functions they have always performed. In essence, the customer is an investor in the partnership, and becomes the first major customer, and will share in future profits if the venture attracts new external customers. The two companies that are leading the charge for enterprise partnerships are Exult and Xchanging.

Exult

Exult is based in Irvine, California and has warranted significant attention through their equity relationships with Bank of America and British Petroleum. In 10-year contracts valued at more than $2 billion, their investors have transferred over 1,000 employees to Exult in exchange for guaranteed cost savings and a share in Exult's profits.

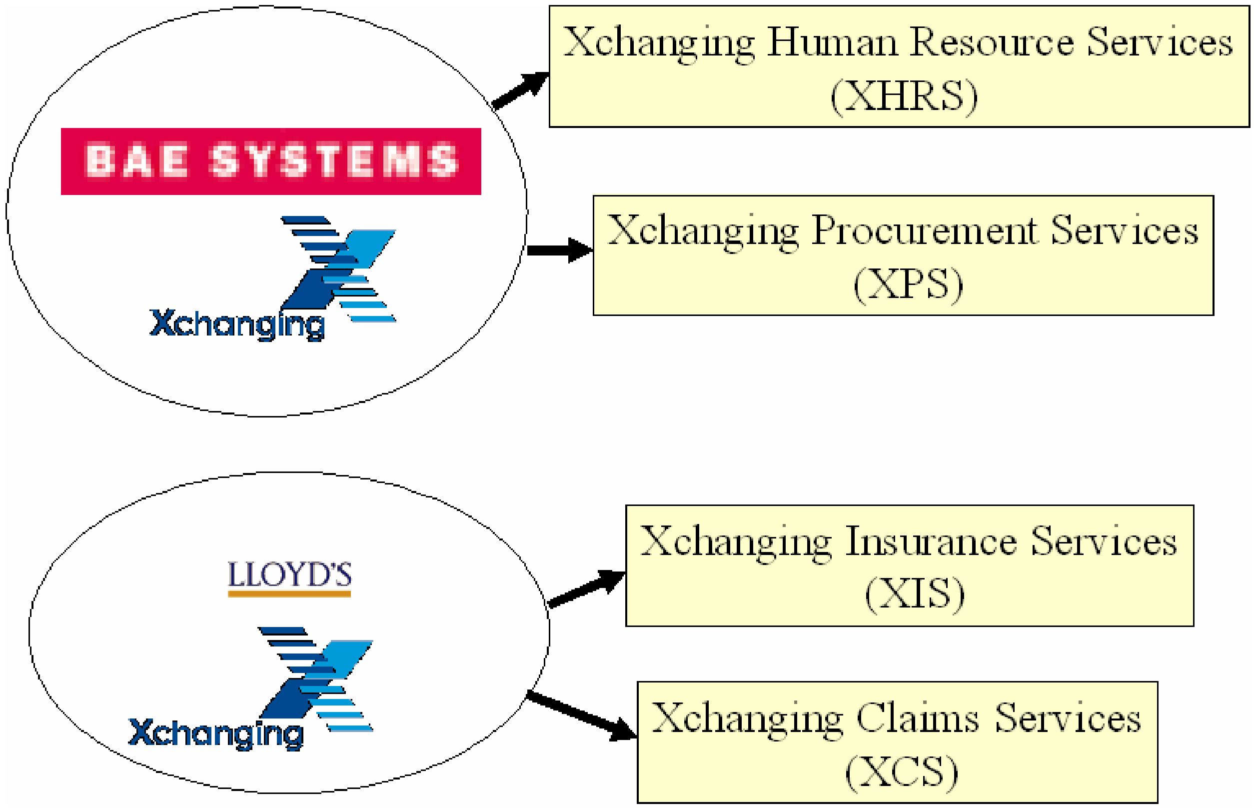
The Bank of America agreement involved taking over the bank's HR processes. The agreement consisted of a 10 year contract worth $1.1 billion. The agreement provided for 700 HR employees from BofA to be transferred to Exult, thus becoming Exult employees. Exult would deliver accounts payable, payroll, HR call center, HR technology, benefits, and regional staffing. Exult guaranteed cost savings to BofA, and in turn, BofA took equity share in Exult and will share in future profits.

Thus far, Exult has won significant contracts beyond BofA and British Petroleum, including a $700 million contract with Prudential Financial and a $600 million contract with International Paper.

Xchanging

Xchanging is a UK based company that has already created four enterprise partnerships with customers:

- *,* XHRS with British Aerospace (BAe), provides human resource management BPO. As the venture's first customer, BAe signed a 10-year, £250-million contract and transferred 430 human resources employees to the venture.
- *XPS,* also with BAe, provides procurement BPO. Again, BAe is the venture's first customer, and they signed a 10-year, £800 contract.
- *XCS and XIS,* with Lloyd's of London, provides policy administration and claims-processing BPO. Lloyd's signed a 10-year, £400-million contract with Xchanging.



In these ventures, BAe and Lloyd's are guaranteed undisclosed cost savings and service improvements on the business process and will share the ventures' future profits. The success of these deals depends on Xchanging's ability to deliver on the contracts and attract external customers.

Xchanging and British Aerospace: What We Learned

Prior to the Xchanging partnership, HR at BAe:

- Lacked investment
- Lacked leadership
- Lacked employee motivation
- Lacked customer-focused service
- Was bureaucratic with inefficient processes, and
- Had outdated and non-integrated technology

The preliminary findings assess the effectiveness of using an enterprise partnership as a vehicle for transforming this low functioning back office into a commercial enterprise:

Finding 1: The Enterprise Partnership Model creates a clash of cultures, but cultural incompatibility may be just what you need.

Finding 2: The Enterprise Partnership Model offers multiple short-term implementation phases that yield faster results and pose less risk than a single, large-scale project.

Finding 3: The Enterprise Partnership Model views technology not as a solution, but as an enabler.

Finding 4: With employing Fee-for-Service Outsourcing or an Enterprise Partnership Model, be sure to manage user demand.

Finding 5: Both Fee-for-Service Outsourcing and the Enterprise Partnership Model uncover spending previously hidden in decentralized budgets.

Finding 6: The Enterprise Partnership Model delays due diligence until after the contract is in effect, which speeds the negotiation process and more fairly distributes the burden of newly discovered costs.

Finding 7: The Enterprise Partnership Model aligns incentives better than fee-for service outsourcing.

Finding 8: The Enterprise Partnership Model does not perfectly align incentives.

Finding 9: The Enterprise Partnership Model benefits from generic business competencies rather than domain-specific knowledge.

Finding 10: The economics of the Enterprise Partnership Model need to work for the client and supplier without over-reliance on third-party revenues.

Is This Right for Your Company?

Enterprise Partnership BPO may not be right for every company, but for the right organization, the success received by BAe may possible be replicated. Xchanging describes the ideal customer profile as:

- The customer has a large back office spending of at least £25 million per year and at least 500 employees, making the deal large enough to attract a competent external supplier.
- The customer's back office operations are highly decentralized, allowing the opportunity for significant savings from centralization and standardization.
- The customer's back office operations have not received high management attention historically, allowing the opportunity for significant savings and service improvement from better management.

- The customer's organization would resist centralizing and standardizing themselves due to internal political resistance, unwillingness of senior management to make the required upfront investment, or lack of skills and experience of back office staff to make the transformation.

Conclusion

Whether your organization wants to outsource a simple application, or you feel that enterprise partnership BPO is right for you, Mary Lacity leaves you with some proven practices to help in your outsourcing endeavors:

1. Use a selective sourcing strategy rather than all-or-none outsourcing strategies.
2. Identify core IT capabilities to keep in-house.
3. Identify non-core IT capabilities for potential outsourcing.
4. Conduct a rigorous evaluation of market options and supplier offerings.
5. Clearly define IT outsourcing expectations and mitigating risk in a contract.
6. Implement post-contract management processes and structures to enable supplier success.