Achieving world-class business process operations:
A comparison of outsourcing and shared services

An analytical framework for the Make/Buy decision

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Overview

One of the hot topics circling the C-suite these days is what should companies do with their back-office operations. Executives are taking a hard look at how to optimize their company’s operations and asking themselves the fundamental question: should we consolidate in-house and build a captive shared services center (“Make”) or should we outsource these functions to a third-party business process outsourcing (BPO) provider (“Buy”)?

This document explores several of the key issues and provides a depth of understanding of the trade-offs involved in the Make/Buy decision, including:

- What factors are driving the renewed focus on the back office?
- Which structures have emerged and how do they compare?
- How do the economics of Make and Buy compare?
- What are the key questions to be addressed when making the Make/Buy decision?

Renewed focus

Increasing market and competitive forces are driving today’s business executives to evaluate their support functions such as finance, procurement, human resources, and information technology.

Market forces

Market forces are pressuring executives to provide year over year cost reductions and profitability improvements, while at the same time, increase the “predictability” of their earnings forecasts. Add that to the increased business controls requirements imposed by the Sarbanes-Oxley Act and personal liability at the senior management level, and companies are faced with a delicate balancing act between reducing costs and increasing controls.

Competitive forces

Industry consolidations, increasing pressure on margins, and globalization are a few of the competitive forces companies face today. As a result, companies must focus their energy and their resources on their core businesses. Support functions in today’s competitive environment are being asked to contribute to the strategic direction of the company. To achieve this, many companies are looking to shed their non-core transactional activities and are struggling with determining which type of delivery structure will best meet strategic, operational, and growth objectives.

Delivery structures

Two types of models have emerged as the primary delivery structures for transaction processing and non-core support function services: insourcing/shared services (Make) and outsourcing/BPO (Buy).

Make

In the Make delivery structure, companies typically establish centralized operations for transactional processing and delivery of non-core support functions in a captive shared services center. Efficiencies are realized primarily through redundancy elimination, process standardization, scale effects, and in some cases, wage arbitrage. Many companies also use the opportunity to re-engineer their processes and implement technology improvements.
**Buy**

In the Buy delivery structure, management of transactional and non-core activities is transferred to a third-party BPO provider. The BPO provider delivers specific functions and processes to customers at agreed upon pricing and service levels, which are generally guaranteed for the life of the contract (typically seven to ten years). In addition to guaranteed savings and service levels, benefits include the ability to rapidly scale operations up or down as market condition warrant, the conversion of fixed costs in to variable costs, and the elimination of systems upgrade and maintenance requirements.

An interesting point to note here is the recent trend of companies moving from an insourced shared services model to an outsourced model. As the BPO market has matured and outsourcing has become a more viable option across industries and functions, many of the early adopters who initially chose insourcing and established their own shared services operations have since decided to either outsource those operations or spin them off as separate entities. Recent examples include Proctor and Gamble, International Paper, and General Electric.

**Comparing Make and Buy**

The primary differences between the two models can be segmented into three categories: operating model, business focus, and risk and controls.

**Operating model**

Organizations that use insourcing do not generally charge market prices to the business units and are seldom able to reinvest their “profits” (assuming they are not run as a cost center) into the shared services operations. Scale efficiencies are realized through consolidation of processing activities and delivery centers but are limited by the size and transaction volume of the company. Governance tends to be less formal with many companies running their shared services operations as a separate business unit.

BPO is a highly competitive market with aggressive market pricing. Providers typically leverage established multi-location delivery infrastructures and can support their pricing levels by achieving substantial efficiencies through multi-client scale, implementing best practices across clients, continuous investment in systems and process improvements, and labor arbitrage. BPO can reinvest their profits in their core business—optimizing business process operations. Formal governance structures are contractually established to manage the relationship between the customer and BPO supplier.

**Business focus**

Insourced shared services are often considered to be “back office/overhead” functions and not the core business of the company. Decision-making is done in conjunction with corporate objectives, and profits are often returned the business units rather than reinvested in the shared services center operations. Corporate objective setting generally focuses on cost reduction rather than service level improvement. The repetitive nature of the work and limited career pathing tends to result in higher employee turnover.

For BPO providers, on the other hand, back office functions are the core business. Therefore, they can focus their full attention and resources on delivering cost and service level improvements. Profits are reinvested in enabling technologies and best practices, allowing BPO providers to remain at the leading edge of process efficiency and service level delivery. Expanded career opportunities and incentive structures enable BPO providers to better attract and retain the most talented resources.
Risk and controls

One of the primary risks faced when insourcing operations, especially to an offshore location, is that there is often a lack of internal expertise on how to migrate processes without disrupting the business. In addition, companies tend to underestimate the complexity of operating centers in offshore locations such as India, China, and Eastern Europe where political and cultural issues can dramatically affect operations and increase the transition time. However, because the operations are still maintained in-house, there is a somewhat lower risk of intellectual property loss, and companies generally feel a greater sense of security around business controls.

In the case of BPO, there is often a perception of higher risk. However, much of the perceived risk is focused on the belief that through outsourcing, companies can lose control. Indeed, much of that risk can be mitigated through proper governance and business control structures. In fact, in some ways, outsourcing can help lower risk. For example, one of the big risks companies fail to adequately plan for when building captive centers is cost overruns and incorrect assumptions about transition activities. Large BPO providers have extensive transition experience and are likely to be better able to budget, plan, and execute migrations. BPO providers also guarantee costs and performance levels so companies are not at the mercy of the assumptions built into their internal business cases as they would be for insourcing.

Figure 1. Comparing Make and Buy

Make vs. Buy comparison

<table>
<thead>
<tr>
<th>Operating Model</th>
<th>Business Focus</th>
<th>Risk</th>
</tr>
</thead>
</table>
| **BPO**         | • Full focus on the “core business” of BPO processing  
|                 | • Continuous investment in process enabling technology and best practices  
|                 | • Focus on meeting Service Level Agreement metrics measuring quality and cost  |
|                 | **BPO**         | • Large providers operate a global delivery network with established disaster recovery infrastructure  
|                 |                 | • Extensive experience in migrating process and operating offshore locations  
|                 |                 | • Performance guaranteed through formal Service Level Agreements  |
| **InSource**    | • Pricing to BU’s often set at corporate level and/or allocated  
|                 | • Capital investments and improvements directly affect company profitability and must be approved at corporate level  
|                 | • Scale limited to company volume  
|                 | • Less formal governance structures  |
|                 | • SSC activities are considered “back-office” and not the “core business”  
|                 | • Profits returned to the BU’s rather than reinvested in the Shared Service Center  
|                 | • Focus on cost reduction  |
|                 | **InSource**    | • Often lack of expertise in process migration and offshore operations  
|                 |                 | • Disaster recovery infrastructure must be established or run risk of extended down time and potential data loss  
|                 |                 | • Savings subject to achieving projected efficiency gains and labor arbitrage  |

Strategic benefits

When the differences between the two models are understood, it is important to evaluate the strategic benefits of each. Both the insourcing and outsourcing models have successful track records, and each has its own benefits. Companies must take into account their long-term objectives, along with their tolerance for risk, and weigh the relative benefits of each option.

The relative benefits for each option are summarized in the following table.
Table 1. Strategic benefits

<table>
<thead>
<tr>
<th>Make/insource</th>
<th>Buy/outsource</th>
</tr>
</thead>
<tbody>
<tr>
<td>– Maintain low risk of intellectual capital loss</td>
<td>– Free up resources to focus on the core business</td>
</tr>
<tr>
<td>– Retain high level of control</td>
<td>– Guarantee significant cost reductions for the duration of the contract</td>
</tr>
<tr>
<td>– Retain 100% of cost savings in-house because there are no profit margins or selling costs to cover</td>
<td>– Guarantee performance levels based on service level agreements (SLAs)</td>
</tr>
<tr>
<td>– Gain ability to leverage company wide scale advantages</td>
<td>– Lower upfront investment required</td>
</tr>
<tr>
<td>– Relatively easier to attain support internally for insourcing than outsourcing</td>
<td>– Faster time to market/steady state than insourcing</td>
</tr>
<tr>
<td>– Less dramatic cultural change</td>
<td>– Gain increased access to innovative technology without major capital investment</td>
</tr>
<tr>
<td>– Faster time to project start resulting from lack of bidding, contracting, and due diligence phases</td>
<td>– Maintain flexibility in tight labor markets</td>
</tr>
<tr>
<td>– Less formal governance mechanisms required to manage shared services operations</td>
<td>– Ability to leverage multi-client scale advantages</td>
</tr>
</tbody>
</table>

Business case

Beyond the strategic benefits, it is important to understand the financial impact of the Make/Buy decision. The following sample business case illustrates some of the key differences between the Make and Buy scenarios. The business case examines four areas:

- Investment required to start operations
- Annual savings from baseline costs after operations have achieved steady state
- Timing to reach steady state
- Overall payback

The business case is modeled on a theoretical company. The baseline is a decentralized, 1,000-person finance and accounting (F&A) organization with transactional processes and a disparate systems environment. In the Make scenario, the factors associated with building a captive shared services center in a low-cost offshore location are examined. In the Buy scenario, the same factors for outsourcing operations to an established BPO provider to the same low-cost offshore location are examined.

Investment

Both insourcing and outsourcing require a substantial upfront investment to implement. The Buy scenario, however, generally has significantly lower investment requirements because of the ability to leverage exiting infrastructure. The key investment elements evaluated in the business case include severance, program setup, site selection, infrastructure, and IT application development.

<table>
<thead>
<tr>
<th>Investment element</th>
<th>Description</th>
<th>Advantage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Severance</td>
<td>Severance is one of the largest investment costs associated with shared services or outsourcing. Severance costs should theoretically be the same for both scenarios.</td>
<td>Make</td>
</tr>
<tr>
<td>Investment element</td>
<td>Description</td>
<td>Advantage</td>
</tr>
<tr>
<td>--------------------</td>
<td>-------------</td>
<td>-----------</td>
</tr>
<tr>
<td>Program setup</td>
<td>The costs included in program setup are those associated with staffing the organization and migrating processes. These include: hiring/recruiting, training, and transition. Program setup costs for the Buy scenario are lower because of several factors:</td>
<td>Make</td>
</tr>
<tr>
<td></td>
<td>– A BPO provider has an established reputation as an employer in its delivery center locations. It has more career pathing opportunities and has been shown to have lower employee turnover than captive operations. It also knows the employment market and has established hiring mechanisms in place.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>– A BPO provider has established training procedures and existing staff and training facilities.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>– A BPO provider has experience and expertise in transition.</td>
<td></td>
</tr>
<tr>
<td>Site selection</td>
<td>For the purposes of this business case, site selection costs apply only to the Make scenario. They are the costs associated with scouting a suitable location to establish a shared services center and the costs to establish a new legal entity. This paper assumes that the for the Buy scenario, there is an existing center, so these costs do not apply.</td>
<td>Make</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>These costs include: setting up the PCs and applications for each employee, PC and phone equipment, building fit out (cubes, common areas, desks, and so on), and technology infrastructure. The BPO costs are lower because of the ability to leverage existing infrastructure such as canteen, meeting rooms, and technology infrastructure. In addition, the BPO provider typically has lower per-seat hardware and software licensing fees because of its scale.</td>
<td>Make</td>
</tr>
<tr>
<td>IT application</td>
<td>It is assumed that in either scenario, the company requires some application development to achieve improved process efficiencies. In the Make scenario, the customer pays for 100% of their application development. In the Buy scenario, it is assumed that the BPO provider can leverage the development costs over multiple customers.</td>
<td>Make</td>
</tr>
<tr>
<td>development</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Savings

After operations achieve steady state, it is possible to compare run-rate savings for each scenario. Savings can be segmented into three categories: process, scale, and wage. For each category, the Buy scenario has some advantage.

<table>
<thead>
<tr>
<th>Savings element</th>
<th>Description</th>
<th>Advantage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Process</strong></td>
<td>Buy has a slight advantage in achieving savings through process efficiencies because BPO providers can focus their full attention and resources on the core business of BPO. This is manifested through continuous investment in technology, process improvements, and best practices. Examples of this can be seen where BPO providers have taken over the management and execution of captive centers and have been able to achieve significant cost and service level improvements.</td>
<td>Make</td>
</tr>
<tr>
<td><strong>Scale</strong></td>
<td>Scale is the area where the Buy scenario has the greatest advantage over Make. Scale advantages are achieved by spreading fixed costs such as building security, conference rooms, and common areas, over a greater volume of transactions and employees. BPO providers can leverage volume from multiple customers to achieve significantly greater scale advantages than captives. Captives can achieve some scale advantages from consolidating their operations in a single center, but those advantages are limited by the company’s internal processing volume.</td>
<td>Make</td>
</tr>
<tr>
<td>Savings element</td>
<td>Description</td>
<td>Advantage</td>
</tr>
<tr>
<td>----------------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>-----------</td>
</tr>
<tr>
<td>Wage rate</td>
<td>Wage arbitrage remains the single largest source of savings when offshoring operations. Both Make and Buy scenarios capture the majority of savings from the wage differential between onshore and offshore operations. Depending on the size of the captive operation and the company’s existing presence and reputation in the region, wage rates for Make and Buy can be nearly equal. However, large BPO providers tend to have a slight advantage as a result of several factors:</td>
<td></td>
</tr>
<tr>
<td>Make</td>
<td>BPO providers have an established reputation in their local markets and can be seen as a preferred provider of employment. New entrants to an area will often have to “hire away” employees at a premium.</td>
<td></td>
</tr>
<tr>
<td>Buy</td>
<td>Attrition rates are generally higher for captives than pure BPO players (for example, in major outsourcing centers in India, industry average is nearly 40% per annum) primarily because pure BPO providers generally provide more opportunity for cross-training and career advancement and have more experience with local employee issues.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>BPO providers are focused on wage inflation and strictly manage increases, whereas captives often view wage increases in absolute terms (total dollars as opposed to %) relative to the domestic rates and are less stringent in keeping wage costs down. In addition, they also are better at aligning work complexity to pay rate and making better use of variable pay structures.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>BPO providers generally have a lower benefits burden than captive operations.</td>
<td></td>
</tr>
</tbody>
</table>
Timing

Experience has shown that it typically takes four to five years to reach steady state and begin seeing transformation level improvements when creating a captive shared services center. In contrast, in an outsourcing engagement, companies can readily leverage the outsourcer’s existing operations and often achieve immediate cost and efficiency improvements. An outsourcing project typically reaches breakeven in two to three years. The factors affecting timing are listed in the following table.

<table>
<thead>
<tr>
<th>Timing element</th>
<th>Description</th>
<th>Advantage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contracting and due diligence</td>
<td>Most companies that chose to outsource operations go through an extensive bid, contracting, and due diligence period before the project can begin. This is not required for insourced operations.</td>
<td>Make: $1.8, Buy: $3.0; Make: $1.2, Buy: $4.5; Make: $12.6, Buy: $14.3; Make: $15.8, Buy: $21.8</td>
</tr>
<tr>
<td>Transition</td>
<td>After the project is given the go-ahead and a BPO provider is selected, the lead time to set up a center is much shorter because of the existence of the provider’s established infrastructure, as well as governmental relationships, local market knowledge, and an existing hiring network. A lack of local market knowledge is a common pitfall for which companies often fail to adequately budget. Knowing how to navigate the political, bureaucratic, and social landscape in a foreign market is one of the key, yet often undervalued advantages that outsourcers provide.</td>
<td>Make: $1.8, Buy: $3.0; Make: $1.2, Buy: $4.5; Make: $12.6, Buy: $14.3; Make: $15.8, Buy: $21.8</td>
</tr>
</tbody>
</table>
Payback

Combining the effects of investment, timing, and savings yields the payback curves for the Make and Buy scenarios. Payback is defined at the point at which cumulative cash flow becomes positive. Comparing the two curves reveals two key points. First, the payback period for the Buy scenario is significantly less than that for Make. The shorter payback is a direct result of the smaller upfront investment, combined with the shorter time to transition and reach steady state and greater steady state costs savings. Secondly, the cumulative savings for Buy are substantially greater than they are for Make because not only are steady state savings greater for Buy, but savings are realized earlier.
After examining the benefits, risks, and economics of both the insourcing and outsourcing delivery structures, it is important to analyze the options in a holistic manner to put this information in context and determine which structure will best meet the needs of a given company.

HP has developed a framework to help structure the overall analysis. The framework is built around six key questions, and answering these questions can help determine which delivery structure best meets a particular company’s needs.

<table>
<thead>
<tr>
<th>Strategic fit</th>
<th>Which structure will best help us meet our strategic and operational goals given our core competencies, competitive landscape, and growth objectives?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic impact</td>
<td>What are the required investments (time and money) versus the anticipated benefits (savings and service level improvements) of each option to our shareholders and stakeholders?</td>
</tr>
<tr>
<td>Required timing</td>
<td>What is the required timeframe to reach steady state and achieve payback on investment?</td>
</tr>
<tr>
<td>Operating model</td>
<td>Which structure will best enable us to achieve best-in-class performance in our required timeframe?</td>
</tr>
<tr>
<td>Cultural fit</td>
<td>Can we view an outsourcer as a partner and will an outsourcing partner offer best-in-class capabilities opposed to insourcing?</td>
</tr>
<tr>
<td>Risk management</td>
<td>What are the regulatory, operational, socioeconomic, and financial risks of each option and how can they be mitigated?</td>
</tr>
</tbody>
</table>

**Make/Buy decision framework**

Cumulative cash flow of $95M for “Make” vs. $164M for “Buy” after 10 years

Source: HP Analysis
How to decide whether to make or buy—Applying the framework

Combining the economics of the business case with the Make/Buy decision framework helps to clarify the decision. Using this framework, you can evaluate a set of conditions, which, if the majority were met, would likely lead a company to choose the Make scenario. Otherwise, outsourcing would generally be a more suitable option.

**Strategic fit**
- The processes in scope are considered to be “core” to the business or are truly unique and therefore not leveragable.

**Economic impact**
- Current processes are at first quartile/world-class performance levels, leaving little room for process and scale efficiency improvement.
- Few constraints exist on capital spending, ensuring funds are available for establishing a captive center.

**Required timing**
- Company has the ability and willingness to wait four to five years to achieve payback.

**Operating model**
- The company has adequate volume from internal operations to achieve required scale efficiencies.
- Internal business units can and will adopt best practices and standardize operations without the formalized structure and discipline created in an outsourcing agreement.
- The company is willing to reinvest profits in shared services to maintain world-class capabilities.

**Cultural fit**
- There is a lack of suitable BPO partners available, or in-scope processes are industry-specific and not currently offered in the BPO space.
- There is a lack of support for outsourcing among senior management.

**Risk management**
- There is a high risk of intellectual property loss.
- The company has an existing disaster recovery network in place.
- There are regulatory constraints that prohibit the outsourcing of processes.

Given the economic and timing advantages of outsourcing, should a company not meet the majority of these conditions, they would be well advised to consider their outsourcing options.

**What to outsource—In-depth assessment required**

The Make/Buy decision is, of course, only the first-level, albeit most fundamental, decision that companies looking to transform their support functions must make. After a decision has been made to make or buy, further in-depth analysis is required to determine the answers to many critical second-level questions, such as:

- Which processes and subprocesses should be included in either a shared services center or an outsourcing agreement? Which should remain decentralized?
- What is the best location to set up a shared services center or to move outsourced operations?
- What operating model and governance structure must be put in place to manage the realigned operations effectively?
Taking the time and effort to answer these questions upfront will help companies to more effectively and efficiently transform their operations.

Conclusion

Today, companies have more options than ever for achieving world-class performance in their support functions. Faced with increasing market and competitive pressures, leading companies are freeing valuable resources to focus on their core businesses. Non-core operations and processes are being sequestered in captive shared services centers or outsourced to BPO providers. Executives must closely examine their strategic, operational, and growth objectives to make an informed decision about which structure will best meet their needs for the future.

HP—A strategic partner for your journey

HP is one of the premier services providers for shared services and outsourcing in the world. Based on first-hand experience and insights, HP has successfully led strategic assessments for numerous enterprises, as well as transformed Fortune 100 companies, commonly regarded as leaders in their industries.

The HP business transformation journey began in the early 1990s when the company set a strategic goal to reduce operating costs by 30% in three years. As a result, HP embarked on an initiative to consolidate current centralized processes to offshore services centers situated in strategic locations throughout the world. This initiative enabled the company to achieve its cost reduction goals, as well as improve service levels well within the allotted timeframe. More importantly, centralization provided a springboard for further process improvement through the use of technology.

Today, HP is recognized for its successful business transformation journey and is viewed as a thought leader in the shared services and outsourcing space. Having transformed its own business and with over 15 years of shared services experience, HP is uniquely positioned to understand the challenges of shared services and help companies navigate the strategic and operational obstacles to build world-class processes. As a result, HP is frequently approached by Fortune 500 companies to conduct shared services and outsourcing feasibility studies, prepare business cases, establish service level agreements, develop detailed implementation plans, and lead implementations of shared services centers and outsourcing arrangements.

Beyond serving clients as a consulting partner and BPO service provider, HP is a well respected and active member of several shared services associations and is regularly asked to speak at conferences on both shared services and outsourcing topics. Underlining its business process excellence, HP was recently honored as one of the “Top 10 most admired shared services organizations” by Shared Services News for the second year in a row.
For more information

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  - +1 650.236.4032
  - Kathleen.g.brumme@hp.com