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Bringing Together Strategic Outsourcing and Corporate Strategy: Outsourcing Motives and Risks

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The authors report the results of a study on the motives of corporate headquarters in large European manufacturing firms for engaging in outsourcing and the risks they perceive to be associated with strategic outsourcing operations. Four main issues can be highlighted: preoccupations about core businesses and reduction of cost of capital are linked; access to external expertise and quality improvements are specific expectations for outsourcing firms; operational cost savings, still a predominant concern, must be balanced with the cost of monitoring suppliers; the 'increased flexibility' objective emerges as a distinct issue.

Keywords: Corporate strategy, Strategic outsourcing, Core business, Risk

Corporate headquarters in large, diversified European companies are under great pressure to create value for their businesses. They must achieve a 'parenting advantage' and strive to be the best possible parents for their businesses (Goold *et al*., 1994, p. 8). To create advantages for their companies, corporate parents, according to Goold *et al*. (2001, p. 85), assume three roles or channels: a minimum corporate parent role that consists of ensuring the existence and development of the firm as a legal entity, a policy-making role and a service provision role for the businesses.

To meet the value creation challenge for their businesses, corporate managers look more and more to outsourcing. Increasingly requiring company-wide policies to be consistent and shared services to help the firm's businesses develop, outsourcing modifies the firm's frontiers. Intense is the pressure from the market and the financial operators to reduce asset investments and to outsource certain activities (e.g. inventory, warehouses or real estate), as these actors expect improvements in the value created for shareholders. Indeed, there is evidence that outsourcing contributes positively to market value (Rappaport, 1986; Alexander and Young, 1996a; Hayes *et al*., 2000). Yet it must also create value for the firm (reduced costs, improved performance) and for the end user. For outsourcing to be meaningful, both value creation and value appropriation processes must be appraised (Alexander and Young, 1996a; Auguste *et al*., 2002).

Outsourcing is a choice that lies in the corporate policy, not just business strategy, area, as it modifies the firm's boundaries as a legal entity and generally involves top management decision makers. Affecting company-wide resource allocation policies and asset management practices, outsourcing decisions often involve several divisions in large, diversified companies, as in the case of IT outsourcing operations.

In the first part of this paper, we review the different features of strategic outsourcing. In the second part, we highlight the current trends in strategic outsourcing. In the following sections, we examine a hierarchy of the motives and risks associated with outsourcing operations. Finally, we propose a number of recommendations that require managers to focus on several key points involved in the implementation of strategic outsourcing operations.

What is Strategic Outsourcing?

In this article, we define outsourcing as the operation of shifting a transaction previously governed internally to an external supplier through a long-term contract, and involving the transfer of staff to the vendor (Lacity and Hirschheim, 1993b; Barthélemy, 2001)[1].

Outsourcing is a trend that will continue over time. It has long been considered as a means to reduce costs, but cost reductions can only be achieved in specific conditions, e.g. the external provider must have access to economies of scale that the outsourcer does not. In short, if outsourcing was reduced simply to performing the same tasks at a lower cost, internal reorganisation may well be a more efficient way to achieve this type of objective (Lacity and Hirschheim, 1993a), especially since managers often find that cost savings are in fact not attained through outsourcing ventures. The switching costs incurred by the transition to an external provider, such as those associated with supplier selection, negotiations, reorganisation and control, are high.

Actually, outsourcing equates with more than just improved operational effectiveness. In fact, it is not limited to peripheral tasks, such as catering or gardening, but involves a growing number of the firm's activities and functions, notably those that substantially contribute to its added value. This notion of strategic outsourcing was introduced by Quinn and Hilmer (1994). However, if most firms in the same industry were to choose the same type of solution, such as outsourcing, the strategic advantage would no longer be valid, as companies would all converge to the same business model (Porter, 1996). To be considered as a strategic choice, outsourcing must be a distinctive feature of specific firms in an industry.

Alexander and Young (1996b) challenge the conventional wisdom that core activities should be kept in-house and evoke several distinctions between the different types of core activities. Activities critical to performance should be distinguished from activities that create a competitive advantage. The first type concerns activities, such as IT, logistics or facilities management, that support the core businesses, without necessarily being a distinctive feature of a specific firm in its market. The second type refers to activities that create a current or potential competitive advantage for the firm.

Strategic outsourcing concerns both of these types of activities that contribute substantially to the firm's added value. By identifying the business functions to outsource, companies can benefit from an increased specialisation in the areas on which they choose to focus, through increased learning, shared experience, professional career path incentives or other ways that enhance value (Alexander and Young, 1996a). Brown *et al*. (2002, p. 65) illustrate the advantages of this type of specialisation, through the description of business networks co-ordinated by companies such as Li & Fung and Cisco.

Due to its strategic importance, outsourcing is a business decision that involves not only operational managers, but also top management. Outsourcing influences the resources allocated to business units as well as the level of vertical specialisation of the firm's activities, both of which are strategic corporate decisions (Grant, 2002, p. 388). Since it deals with modification of the firm's frontiers, strategic outsourcing, deemed as business strategy (Insinga and Werle, 2000), is also a corporate strategy issue.

Outsourcing Features: A General Overview

Strategic outsourcing is now a reality, as illustrated in the following example. In December 2002, JP Morgan Chase's top management decided to arrange a seven-

Five Elements Characterise Strategic Outsourcing:

- ❖ A close link between outsourcing processes and the key success factors of a firm in an industry (Quinn and Hilmer, 1994).
- ❖ The transfer of ownership of a business function previously internalised, often including a transfer of personnel and physical assets to the service provider.
- ❖ A global contract, longer and denser than a classical subcontracting agreement.
- ❖ A long-term commitment between the client and the service provider. Previous research, based on more than one hundred major contracts, shows an average contract duration of 6–7 years (Lacity and Hirschheim, 1993b; Barthélemy, 2001).
- ❖ A contractual definition of service levels and of each partner's obligations (Doig *et al*., 2001).

year, $5 billion outsourcing deal with IBM. The deal was intended to help JP Morgan Chase 'make internal IT costs more flexible by scaling its computing needs in line with internal and external demand.' In view of this objective, the bank opted to let IBM take a major part of its data processing infrastructure. The contract included the transfer of about 4000 JP Morgan Chase employees to IBM this year. For the most part, application delivery and development, desktop support and other core competencies remained in-house at JP Morgan Chase. The deal should help the bank to centralise its IT operations, 'allowing customers to tap into its vast computing network and rent server processing, data storage and other IT resources on a pay-as-you-use basis.'

Computerworld (Computerworld, 2002) reported that senior executives at investment banks are 'often disillusioned with the inability of their IT departments to react quickly to changing market decisions.' They clearly look to outsourcing as a means to reduce costs (insofar as they can be measured effectively), focus on core activities and increase flexibility. This JP Morgan Chase example shows that cost reductions, while important, are but one objective expected from outsourcing. Other objectives include improved flexibility, quality and control. Regaining control of IT departments is an important driver inciting the corporate hierarchy to outsource such activities, as stated by Lacity and Hirschheim (1993b) in a more extensive empirical study. Here, outsourcing is clearly inseparable from the company's long-term vision of core businesses.

The Geodis-IBM case (see Exhibit 1) is also an example of a strategic approach to outsourcing which concerns the outsourcer's key success factors. Here, outsourcing becomes an integral part of an overall policy to exploit core competencies.

The strategic approach to outsourcing provides the firm with information about the main activities that can potentially be outsourced. From headquarters' point of view, the type of outsourcing policies that it draws up can help its business units to benefit from expert advice. Expertise can be provided by service providers or internal specialists. Besides reflecting on different outsourcing policies to adopt, headquarters can also prepare the firm for outsourcing by centralising the provision of certain services so that the business units or support activities derive benefits from economies of scale, or scope. By providing guidelines for their businesses and taking into account the evolution of the competencies portfolio that the Group maintains and develops, headquarters plays a role that involves verifying resource allocation and cultivating the firm's competence portfolio on a company-wide-basis.

Outsourcing is also a tool for top managers to spread risks in a more optimal manner, and to avoid large, often irreversible, investments. Yet, at the same time, outsourcing decisions are themselves costly to reverse. As it grows in scope, importance and contractual complexity, strategic outsourcing calls for an approach to risk that is different from what may have been used for less core-dependent business activities (Alexander and Young, 1996b).

A precise account of outsourcing motives and an assessment of the risks involved provide a basis for sound implementation and control (Lacity and Hirschheim, 1993a; McFarlan and Nolan, 1995). Goold *et al*. (1994, pp.19–21) propose a corporate strategy framework that carefully examines the parent's characteristics by studying its structures, people and skills, functions, decentralisation contracts or mental maps. Mental maps, in particular, 'shape the parent's perceptions of business improvement opportunities'; even if variations exist among the firm's individuals, 'the parent can be characterised and differentiated with regard to its dominant maps.' This article provides an account of the motives of corporate management in major diversified European firms for outsourcing and the risks they perceive to be associated with strategic outsourcing.

New Millennium Trends in Outsourcing

Outsourcing operations are becoming increasingly complex (Cap Gemini Ernst & Young, 2002), involving a growing number of business functions. Companies tend to outsource more mission-critical, complex operations that contribute to their growth. The complexity of outsourcing operations assumes several dimensions:

- ❖ As corporate headquarters become more involved, the number of stakeholders influenced by the outsourcing decision becomes more numerous than a few years ago;
- ❖ Selection criteria are not limited to mere cost savings;
- ❖ Contracts are becoming denser, as agreements become more sophisticated in terms of measurement procedures, financial management of the transferred assets, and re-insourcing clauses;
- ❖ Managing the transition involves the shifting of more complex interfaces between supplier and the outsourcing company;
- ❖ Managing the relationship under more detailed 'service-level agreements' (SLAs) entails more complex operations in terms of control and performance reporting.

Thus, processes to select vendors, negotiate contracts and implement the actual transfer of operations to the external provider have become more protracted and costly to implement.

Exhibit 1: Outsourcing Logistics at IBM

For several years, IBM has tried to focus on more value-added activities such as services, which now account for 40 per cent of its global turnover. Since 1994, in an attempt to exploit synergies better between its different subsidiaries, especially in Europe, IBM's corporate headquarters reduced decentralisation within the Group.

IBM considers that while logistics is not a core business, it is nevertheless a key success factor in PC sales. Although logistics do not enter into the conception of a computer's architecture, its microprocessor or its software, IBM's clients are particularly demanding so far as delivery is concerned. The company has transformed the way it distributes products throughout Europe, the Middle East and Africa. The overall objectives of IBM's outsourcing policy are to reduce costs and inventory while maintaining high service levels for finished goods and critical spare parts. Several outsourcing providers were chosen to cover Europe. In October 1998, IBM signed a 5-year, 1 billion French Francs (150 millions Euro) logistics outsourcing contract with Geodis for Italy, France and Germany, and one year later, for Spain and Portugal as well. The geographic scope of these three European markets would have entailed heavy investments for IBM had it not signed logistics outsourcing contracts.

What IBM outsourced to Geodis
- ❖ Inbound logistics (from suppliers to factories)
- ❖ Flows between factories (5 factories: 2 in France, 2 in Italy, 1 in Germany)
- ❖ Flows from factories to distributors (approximately 500 distributors in the relevant countries)
- ❖ Flows of spare parts for maintenance

What IBM did not outsource to Geodis
- ❖ Transportation purchasing: due to its relative size, IBM believes it can negotiate better terms than Geodis
- ❖ IT systems: IT systems were rationalised in 1997, and centralised in a data centre in Germany. The transfer to several external providers with different systems was seen as a disadvantage.

120,000 m^2 of warehousing and 750 persons from IBM were transferred to Geodis. The relationship has also evolved, with new contracts covering a larger geographical area and including service provisions linked to reverse logistics.

Sources: IBM Press release; Geodis Press release; Usine Nouvelle, 7 January 1999, #2669

Although outsourcing has become a widely accepted business practice, it is not developing as quickly as its proponents would like. Gartner-Dataquest analysts report a moderate growth, +2.8 per cent, in the outsourcing of IT services in 2002, compared to 2001. They warn that: 'IT services companies need to prepare for a longer-term future where double-digit growth is the exception rather than the rule.'

Indeed, there is growing evidence that outsourcing involves high risks in terms of loss of competencies (Bettis *et al*., 1992; Doig *et al*., 2001) and can lead to costly failures, due to the lack of an appraisal of hidden costs (Barthélemy, 2001). According to a recent research by Diamond Cluster International, a Chicago management consulting firm, 78 per cent of executives who outsourced an IT function have had to terminate the agreement prematurely. Their main reasons for dissatisfaction were poor service and change in the strategic direction and cost structure.

Many problems arise when the wrong objectives are sought, or when such objectives become irrelevant, due to changing market conditions or technological evolution. Hirshheim (1998) notes an emerging trend towards 'backsourcing', where companies take their outsourced functions back in-house at the end of the contracts' term. However, outsourcing operations are difficult and costly to reverse. According to a recent study, in IT outsourcing, it may take an average of eight to nine months to switch to a new vendor or to reintegrate a function at the end of the initial contract (Barthélemy and Geyer, 2000).

As companies outsource more strategically though, and as outsourcing increasingly becomes a strategic tool which addresses issues of corporate change in dynamic environments (Elfring and Baven, 1994; Cross, 1995; Baden-Fuller *et al*., 2000), a wider mix of objectives is sought. The quest for cost savings may no longer be the optimal choice. Actually, the main challenge when outsourcing is how to manage short-term cost savings while keeping in mind long-term perspectives for competencies and reputable suppliers, both of which are linked intimately to quality of service.

Exhibit 2: Examples of Outsourcing Mega-Deals at a Glance*

Information Technology

IT services remain the more mature and most important activity outsourced in large companies. In recent years, 'mega-deals' (global IT outsourcing contracts worth above $1 billion over 5 to 10-year periods) have been signed. According to Gartner-Dataquest, at year-end 2002, at least 14 IT outsourcing mega-deals worth a total of $28.4 billion were signed, close to twice the nine mega-deals in 2001, worth $15.1 billion in total. Recently, major corporations have signed important outsourcing deals, as shown in the following examples:

Date	*Supplier*	*Outsourcer*	*Contract Duration*	*Total Contract Value*
December 2002	IBM	J. P. Morgan	7 years	$5 billion
December 2002	EDS	Bank of America	10 years	$4.5 billion
December 2002	IBM	Deutsche Bank	10 years	$2.5 billion (estd.)
January 2001	EDS	Sabre Holdings	10 years	$ 2.2 billion
June 2000	EDS	Xerox	10 years	$3.6 billion

Business Process Outsourcing

More recently, business process outsourcing (BPO) contracts, mainly focused on human resources (HR) services management, such as payroll administration, have been signed. For example, in early 2001, Bank of America and Exult signed a 10-year, $1.1 billion HR services outsourcing contract. BAE Systems and Xchanging signed a 10-year, $1.15 billion contract for procurement operations management.

Date	*Supplier*	*Outsourcer*	*Contract Duration*	*Total Contract Value*
January 2002	Exult Inc.	Prudential Financial	10 years	$700 millions
October 2001	Xchanging	BAE	10 years	$1.15 billion
February 2001	Exult Inc.	Bank of America	10 years	$1.1 billion

Production

Date	*Supplier*	*Outsourcer*	*Contract Duration*	*Total value of the contract*
January 2003	Sanmina	IBM	3 years	$3.6 billion
September 2002	Flextronics	Casio	4 years	$2 billion
January 2002	Celestica	NEC	5 years	$2.5 billion
February 2001	Celestica	Avaya	5 years	$4 billion

Logistics

Date	*Supplier*	*Outsourcer*	*Contract Duration*	*Total value of the contract*
March 2003	TNT	Telecom Italia	3 years	$ 139 million (estd.)
June 2002	Exel	Interbrew	8 years	$730 millions (estd.)
October 2001	Samsung	UPS	5 years	$500 millions
May 1998	Geodis	IBM	5 years	$170 millions (estd.)

*We list here only the details of outsourcing contracts as they were reported at the time of their first announcement. All values are cited in US dollars and were converted at the exchange rate observed at the time of the announcement.

The 2002 HEC Survey

Objectives

This study aims to identify the main drivers, both internal and external (such as environmental dimensions), which encourage companies to outsource business functions. It also focuses on the criteria used in the decision-making process and risks associated with outsourcing. While outsourcing motives and risks are generally well identified in the literature, most contributions provide extensive lists, but fail to indicate the different contexts to which these motives and risks apply and how their importance varies accordingly. Outsourcing operations are generally assessed at the business division level; the specificity of the perceptions of outsourcing at the corporate level remains to be highlighted.

Exhibit 3: Survey Methodology

Interviews
From December 2001 to March 2002, we conducted 25 semi-structured interviews with top managers with corporate responsibilities in 20 large European manufacturing groups. A large spectrum of respondents was solicited: the companies are from four different European countries: France, Germany, Italy and Belgium. The industries represented include: Oil & Gas extraction and refining, Rubber products, Concrete products, Steel and Metal processing, Chemical products, Pharmaceuticals, Glass products, Electronic equipment, Aircraft engines, Automobiles and Food products. These interviews were then completed with four service providers in the IT, Logistics and Telecommunications businesses. The interviews lasted between 1 and 3 hours, the average duration being 1 hour 30 min. The qualitative analysis of the interviews helped us to draw up a 12-page questionnaire.

Quantitative Study
The 25 interviews helped to identify the main dimensions that top management perceives to drive the outsourcing decision. A 12-page questionnaire highlights the context in which the decisions were made (economic environment, competitors' choices, suppliers' services), the extent to which the firm has already outsourced, the positive factors and the risks perceived. To address the different facets of outsourcing, 18 activities were considered in the questionnaire. This first semester 2002 survey of European manufacturing firms aims to identify the motivations behind the decision to outsource and the risks associated with this type of business arrangement. Based on the answers of corporate managers in large manufacturing companies, representing seven Western European countries, 180 questionnaires were analysed.

The Scope of Activities Outsourced

In each European manufacturing company studied in our survey, numerous activities are affected by the outsourcing phenomenon. Of the 18 activities considered in the questionnaire:

- ❖ At least eight activities are partially or completely outsourced by 50 per cent of companies in the sample;
- ❖ At least four activities are partially or completely outsourced by 80 per cent of companies in the sample;
- ❖ On average, companies in the sample partially (or completely) outsource seven activities.

Managers clearly indicated that, of the 18 activities or functions studied, the five below are the most affected by outsourcing (cf. Figure 1):

- ❖ office information technology;
- ❖ industrial maintenance;
- ❖ waste management;
- ❖ logistics;
- ❖ telecommunications.

These activities have been partially or completely outsourced in a large number of companies. Most of them are complex processes, but are considered by most industrial companies to be part of their core functions. We note that the functions which are more central to many companies' core activities, such as finance, marketing, accounting and sales, remain the least affected by outsourcing.

The three activities most commonly cited as having the greatest outsourcing potential within the next two years (cf. Figure 2) are:

- ❖ office information technology;
- ❖ logistics;
- ❖ wage management.

While IT functions are already outsourced extensively, they still have great potential to be further outsourced. That logistics and wage management are commonly outsourced indicates a tendency by large companies to consider outsourcing more complex business processes, rather than just basic services.

A more global picture of the potential to outsource the 18 main business functions required by most manufacturing companies can be seen in a matrix with four distinct quadrants (cf. Figure 2):

- ❖ A first group of business functions are already outsourced in many companies and will tend to be further outsourced in the near future: IT, logistics, payroll processes and telecommunications. The larger contracts have been signed in these areas. They are support functions for the core businesses, and great possibilities exist for sharing costs and economies of scale, not to mention a base of competencies which have developed over the years.
- ❖ A second group of business functions which are still not very widely outsourced, but which increasingly may be done in the next two years: facilities management, accountancy, and industrial maintenance. In these areas, the possibilities for sharing also exist, although they may not be as numerous as in the first group of activities.

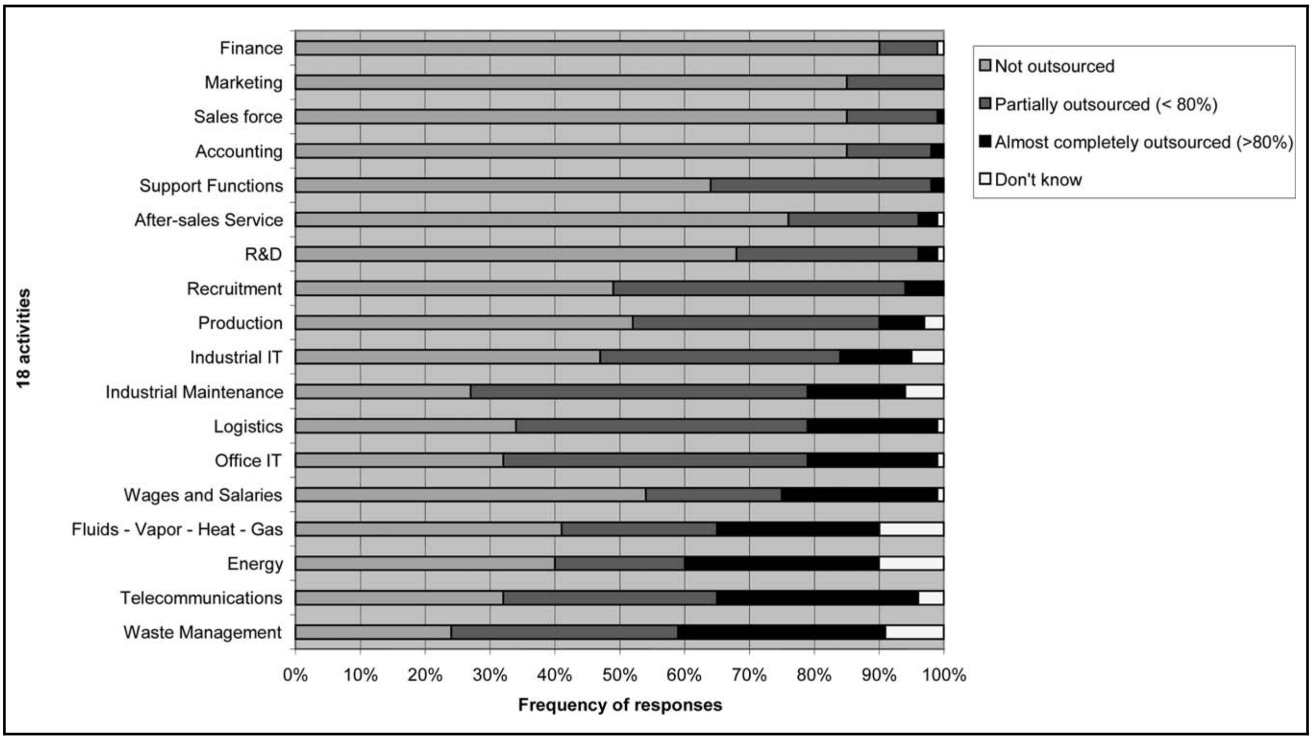


Figure 1 State of Outsourcing Business in the 180 Participating Firms

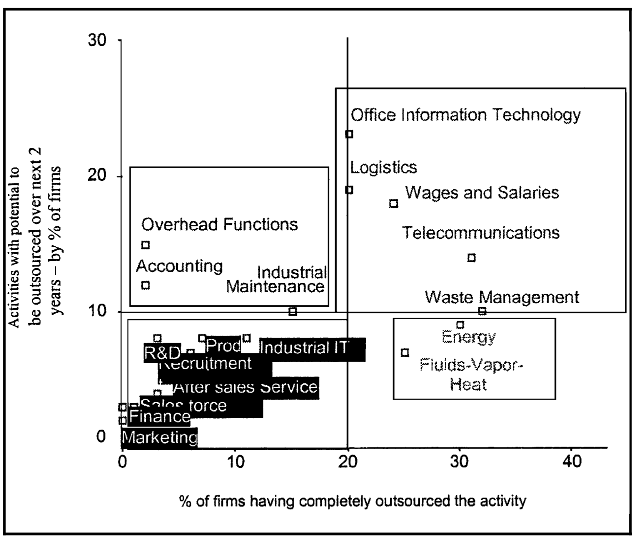


Figure 2 Activities with the Potential to be Outsourced Over the Next Two Years

- ❖ A third group of business functions includes activities which are already outsourced quite extensively, but will not be further outsourced in the future: waste management, energy and fluids. Recently, several suppliers have developed services in these areas. Service providers find it difficult to show they can obtain more economies of scale than their clients.
- ❖ A fourth group of functions, seldom outsourced, and for which the outsourcing potential remains weak are: marketing, finance, after-sales services, finance, recruitment, R&D, production, and industrial data processing. These business functions which most companies are still reluctant to outsource are clearly the more strategic activities that constitute sources of core competencies and/or competitive advantages.

Environmental Context of Outsourcing Decisions

Our study shows the existence of a common set of objectives considered as being important when making outsourcing decisions at the *corporate level*. Notably, we stress the specific importance that headquarters attribute to the costs of investment.

Importance of the Environment and Economic Context
When we first conducted our research, we considered that changes in firms' external environments play an important role in the appraisal of outsourcing decisions. A thorough review of literature and the data gathered from our interviews enabled us to consider a wide array of situations. We used these to identify, in the most comprehensive way possible, the different environmental dimensions which top management considers likely to influence or determine their outsourcing decision. We can highlight seven such dimensions:

- ❖ Speed of technological change in the core activity;
- ❖ Uncertainty surrounding the demand;
- ❖ Timing;
- ❖ Internal structures and the firm's historical evolution;
- ❖ Market maturity of the activity considered;
- ❖ Degree of internationalisation of the activities considered;
- ❖ Quality of the service provider's proposal.

We then included these seven dimensions in the questionnaires. We subsequently used the results to evaluate the importance of the external factors that promote outsourcing and compared these with internal factors. Our main finding, surprisingly, is that the environment is not considered to be a truly dominant criterion in the outsourcing decision.

External factors prompting a company to outsource are, for example:

- ❖ frequency of technological process and product evolutions,
- ❖ speed of new product launches on the market,
- ❖ seasonal nature of the activity,
- ❖ cyclical character of the firm's markets,
- ❖ degree and frequency of fluctuations in the workload,
- ❖ uncertainty about future markets.

These are considered by the managers questioned to be important, but non-dominant, with average scores of approximately '4', on a scale of 1–7 ('1' being least important). As for the two external factors 'service providers' sales efforts' and 'urge to copy competitors', they are not considered to affect in any significant manner the decision to outsource (these factors are deemed important for only 24.1 and 38.1 per cent of respondents, respectively).

Investment renewal, on the other hand, is considered to be an important factor by a great number of managers (64.2 per cent of respondents), prompting them to engage in outsourcing operations. Likewise, an activity's capital intensiveness and the pressure of financial markets both influence the outsourcing decision (for 51.7 and 46.7 per cent of respondents, respectively).

Outsourcing Motives

A large number of publications list many motives for outsourcing. Table 1 indicates the main motives scholars and practitioners in this field have identified.

Decision Criteria for Outsourcing

The questionnaire was structured in two steps:

- ❖ Ranking, by decreasing order, of the importance of the various decision criteria;
- ❖ Classification, by proximity, of the main decision criteria.

From the analysis, we found that the most important criteria when making outsourcing decisions are:

- ❖ The first most important criterion is to lower operational costs;
- ❖ The second most important criterion is to focus on core activities;
- ❖ The third most important criterion is to gain flexibility.

Outsourcing is a means to lower costs. That operational cost savings are a primary reason encouraging firms to outsource highlights the perception managers have of the role which outsourcing plays in improving a firm's operational efficiency. This cost reduction objective, can also be achieved by rationalising and by cutting costs internally, notably by sharing resources. Our study shows that outsourcing addresses other important objectives besides that of cost savings. For instance, it can also be seen as a tool of growth for the firm's core business activities.

To better understand how these criteria are analytically connected, it is necessary to:

- ❖ verify that each criterion is independent when interacting with the others;
- ❖ distinguish the importance of the criteria by type of activity.

Factor analysis was used to identify four distinct types of decision criteria, and to separate them analytically.

For Managers, Issues Concerning Core Businesses and Cost of Capital are Related

The study establishes a link between a company's focus on its core business and a decrease in its cost of capital.

Table 1 Main Motives Highlighted in the Literature

Main motives identified	*Main references*
To reduce operational costs	Lacity and Hirschheim (1993b); McFarlan and Nolan (1995); Barthélemy and Geyer (2000); Kakabadse and Kakabadse (2002)
To focus on core competencies	Quinn and Hilmer (1994); Saunders *et al*. (1997); Alexander and Young (1996b); Kakabadse and Kakabadse (2002)
To reduce capital invested	McFarlan and Nolan (1995); Kakabadse and Kakabadse (2002)
To improve measurability of costs	Barthélemy and Geyer (2000)
To gain access to external competencies and to improve quality	Quinn and Hilmer (1994); McFarlan and Nolan (1995); Kakabadse and Kakabadse (2002)
To transform fixed costs into variable costs	Alexander and Young (1996a)
To regain control over internal departments	Lacity and Hirschheim (1993a); Alexander and Young (1996a)

This first factor reveals the link between strategic focus on the core business and the best possible use of the manufacturer's capital investments.

It is not reducing the cost of capital in an isolated manner that is important. It seems this criterion cannot be dissociated from the management of core competencies.

Indeed, the analysis establishes a link between such preoccupations as 'lowering the weighted average cost of capital' and 'improving the use of capital investments' on the one hand, and 'focusing on high value-added activities' and 'concentrating the firm's human and capital resources on its main activities' on the other.

Gaining Access to External Expertise is a Specific Expectation that Client Firms Have in Outsourcing Operations
The second factor highlights the opportunity to use external expertise, particularly when a firm reinvests.

In fact, 'improving performance and quality' and 'gaining access to service providers' expertise' are associated with a 'low qualification level of personnel in certain functions'.

This implies that when reinvesting in certain activities, companies perceive a gap between the performance, expertise and qualifications that exists internally and those available in the outsourcing marketplace.

Such an observation motivates them to outsource.

Reduction of Operational Costs Implies a Need to Monitor the Supplier's Performance in Terms of Costs, Quality and its Capacity to Evolve over Time
The third factor emphasises the issue of achieving operational cost savings while maintaining tight control over the service provider's actions. It corresponds to clients' strong expectations about vendors' productivity efforts, so that a high level of quality is maintained throughout the term of the contract.

The study shows that the frequently cited operational cost savings motive cannot be dissociated from a continuous control and monitoring of the quality of services provided. Savings must be achieved at the cost of monitoring the supplier's performance, as outsourcing necessarily means a loss of direct control over quality, timing and service provision (see below.)

The services provided must evolve over time and the vendor must be prepared to support its clients in their globalisation efforts.

Outsourcing is a Means to Gain Flexibility
From this fourth factor emerges a distinct concern linked to the flexibility outsourcing generates. Companies have a dual expectation from service providers:

- ❖ they adapt to the evolutions of their clients' market and needs;
- ❖ they provide and adjust means and resources to establish a fit with client expectations.

In their efforts to optimally manage business upturns and downturns, companies look to outsourcing as a means to gain the flexibility they otherwise would not have been able to achieve internally.

Who Decides and How?

In identifying external and internal factors that may encourage firms to outsource, a paradox becomes evident: the perception of a corporate outsourcing policy does not contradict the practice of decision-making on a case-by-case basis. Our interviews highlight the fact that most firms in the sample tend to react according to opportunities that arise. Generally, there is no predetermined plan.

The quantitative analysis enabled us to refine this judgement. Overall, almost 70 per cent of managers questioned consider the outsourcing decision to be highly centralised in their firm. Yet, while 51 per cent estimated there was a clearly defined outsourcing policy, almost 80 per cent stated the opportunities were treated on a case-by-case basis.

Insofar as outsourcing policies are concerned, investment committees and financial departments guide the manufacturing companies. Although investment records are often elaborated by operational departments, they are usually thoroughly examined by financial departments. When there is a need for new investments, outsourcing initiatives can be taken; in this case, the client waits for the vendor to defray the cost of new investments.

Why do Companies Outsource Certain Business Functions?

We identified several features among company-wide strategies. The assessment also varies according to the different businesses or functional levels. For the outsourcing of fluids – water – gas and facilities management, the main objective is cost reduction. Outsourcing of accountancy, payroll management and waste management is also mainly associated with the search for operational cost savings. Access to external competencies motive dominates R&D, marketing and recruitment. The objective to decrease the cost of capital is more frequently associated with the outsourcing of fluids – water – gas and energy management.

Four Insights can be Drawn from the Data Analysis at the Corporate Level:

❖ Corporate managers perceive an association between preoccupation about core businesses and decreasing the cost of capital. This perception is specific to corporate management.
❖ Gaining access to external expertise is a specific expectation that client firms have when they outsource.
❖ Operational cost savings must be achieved, but at the cost of a certain loss of control.
❖ Outsourcing is a distinct means to gain flexibility.

As different business activities follow a different rationale, these general objectives or decision criteria for outsourcing must be differentiated (cf. Figure 3). The objectives pursued must be compounded with a clear assessment of the risks involved so as to improve choice of the organisational arrangement which is most relevant to managing each of the different business functions.

Outsourcing Risks

Our method used for the risk analysis is similar to that used for the decision criteria analysis.

The analysis was conducted in two steps:

❖ Ranking, by decreasing order, of the importance of the various decision criteria for outsourcing;
❖ Classification, by proximity, of the main decision criteria.

Following Aubert *et al*. (1998), we define outsourcing risks as negative consequences confronting the outsourcing company following outsourcing operations. These risks are summarised in Table 2:

The most important risks that emerge from the analysis are:

❖ Risk of dependence on the service provider
❖ Risk linked to the service provider's deficient capabilities.

The first issue concerns **risk of dependence** on the vendor. Contractual by nature, these risks express companies' fears of not having a safety net if and when the vendor fails to deliver the expected service in a timely manner. The risk of not being able to control quality is also a major concern. These concerns clearly manifest the belief that it is difficult to change vendors or to bring the activity back in-house after the contract has terminated. In the long-term, the firm takes the risk of no longer possessing the necessary know-how to understand, analyse and therefore to control the evolution of a service or an activity.

The second main fear expressed involves the **service provider's capabilities**, which can manifest themselves in a 'scarcity of financial resources', an

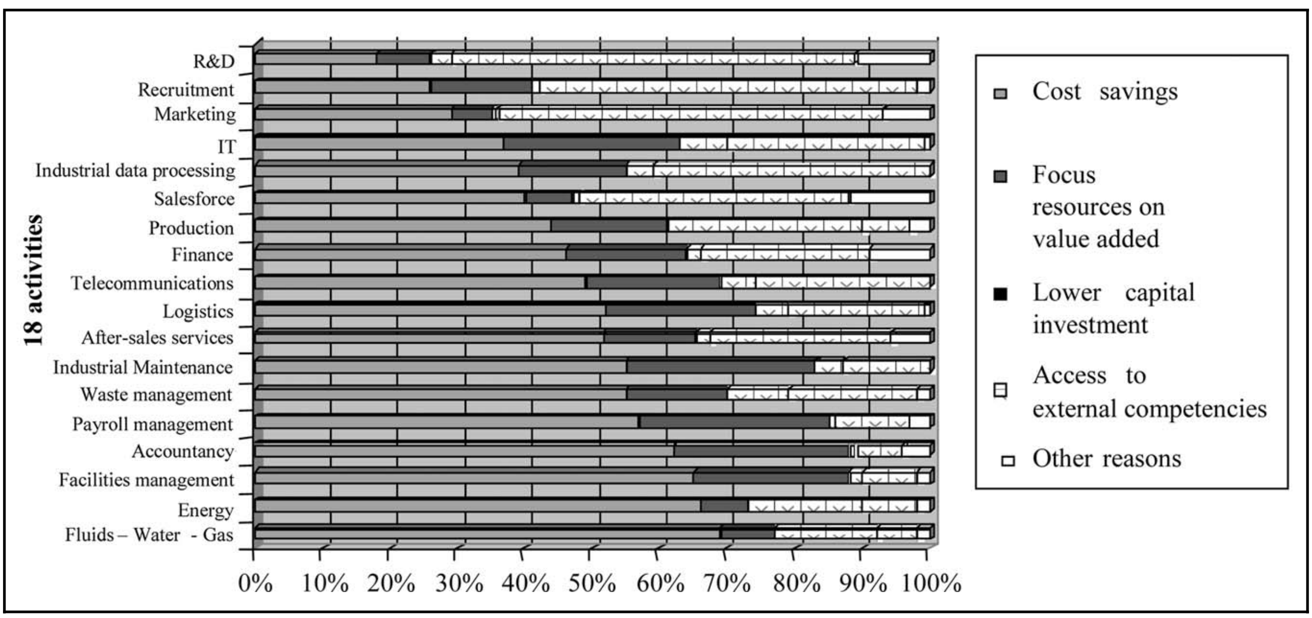


Figure 3 The Main Reasons for Outsourcing — By Activity

Table 2 Main Risks Identified in the Literature

Main negative outcomes	*Main references*
Dependence on the supplier	Alexander and Young (1996b); Aubert *et al*. (1998)
Hidden costs	Earl (1996); Alexander and Young (1996b); Aubert *et al*. (1998); Lacity and Hirschheim (1993a); Barthélemy (2001),
Loss of know-how	Bettis *et al*. (1992); Martinsons (1993); Quinn and Hilmer (1994); Khosrowpour *et al*. (1995); Alexander and Young (1996b); Earl (1996); Aubert *et al*. (1998); Doig *et al*. (2001)
Service provider's lack of necessary capabilities	Earl (1996); Aubert *et al*. (1998)
Social risk	Lacity and Hirschheim (1993b); Barthélemy and Geyer (2000)

'absence of internationalisation' and 'insufficient knowledge of the client's activities'. These issues refer to the service provider's financial strength, its international dimension and its past experience. They determine the provider's capacity to evolve together with the outsourcer in a dynamic business context.

As outsourcing often entails a long-term contract which cannot take into account all future contingencies, the service provider's capacity to adapt its offer, both geographically (accompany its client) and technically (being at the cutting edge of technology), in a changing business context and its capacity to make necessary reinvestments are crucial. The perception of the risk that service providers lack these capabilities may cause top management to dismiss the outsourcing choice altogether. These perceived risks are effectively linked to the service provider's life expectancy. For this reason, we note that in many cases, markets are oligopolistic by nature, dominated by large vendors, except perhaps in the industrial maintenance industry.

Ecological risks are generally not perceived to be a determining factor in the outsourcing decision. Likewise, **social risks**, prominent in many studies, are not considered to be very important by our sample of European managers. Nonetheless, we note that French managers tend to assign greater importance to social legislation than other European managers.

All in all, the risks perceived warn managers about outsourcing while pressure to yield high performance and make new investments encourages them to favour these types of business operations.

Perspectives

This study confirms that top management in European manufacturing companies maintains a particular view of outsourcing. This perception transcends the more contextual approaches that operational managers use.

How Core Competencies and Financial Logic are Related

As can be expected, corporate headquarters devote much attention to financial management issues. The cost of investments appears more sensitive on the corporate than on the business-unit, or the functional, level. Our interviews tend to confirm the existence of a general trend — that corporate headquarters try to instil the discipline of financial markets in their businesses. When a firm's businesses and their potential and future growth are strategically analysed, when investment decisions for asset renewal or growth need to be made, the core business approach is associated with outsourcing. If an activity is not considered to be core to the firm's business, it will not be a priority in investment decisions. If, on the other hand, it is considered to be central and its future development requires heavy investments, the decision-maker will tend to draw up an outsourcing contract stipulating that the service provider covers these costs.

How to Formulate Outsourcing Policies From a Corporate Point of View

As previously stated, corporate headquarters can influence businesses in several ways, most notably by providing general guidelines, such as for outsourcing. Complex outsourcing contracts, fixed at the corporate level, entail a degree of local adaptation. For the decision to be both centralised and customised, a useful way is to draw framework contracts for top management to negotiate with the service provider. Framework contracts can help the business units to economise on transaction costs, such as those associated with finding suppliers and negotiating agreements, and can also provide a means to achieve consistency and control within the firm. Figure 4 proposes a framework to formulate such policies.

Questions about outsourcing often arise when large investments are involved, either imposed by external contingencies or sought proactively by the firm. Such investments should first be considered from the viewpoint of the firm's strategies and competencies

From This Study, Four Conclusions Can Be Drawn

- ❖ A corporate policy can be associated with the practice of a case-by-case consideration of outsourcing opportunities.
- ❖ The financial approach and competencies approach to decision-making for outsourcing are linked.
- ❖ Experience gained from previous outsourcing operations helps make this type of arrangement spread throughout the company.
- ❖ Companies have strong expectations about service providers' professionalism, references and resources enabling them to commit over time.

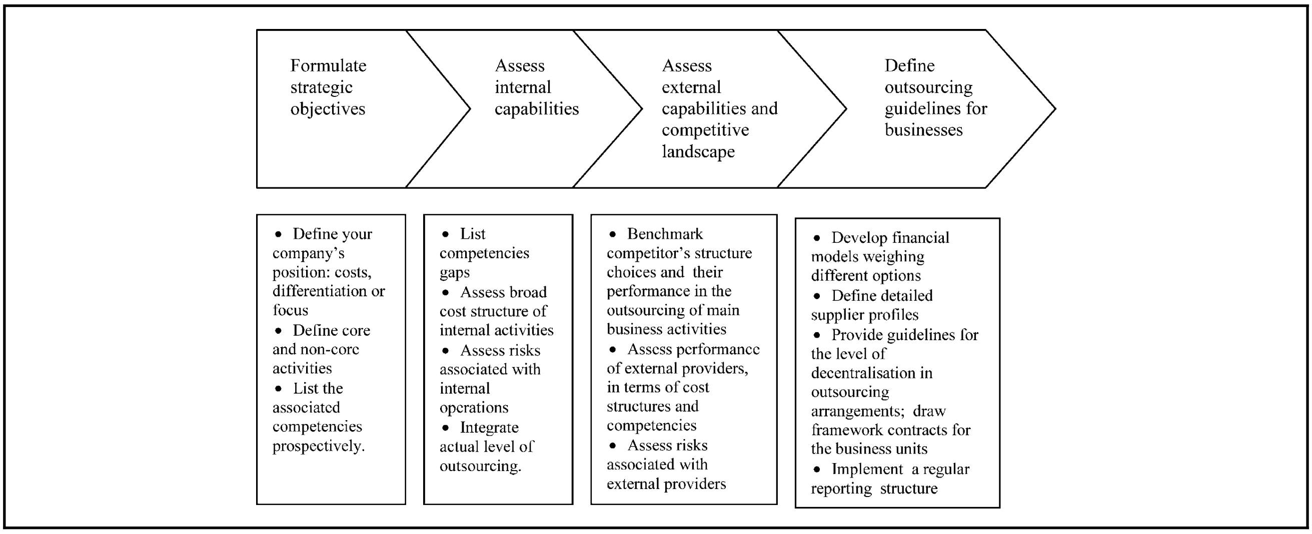


Figure 4 Sketching Overall Outsourcing Policies

needs. The first step of the analysis requires that managers articulate a thorough assessment of their strategic direction and make an appraisal of relevant competencies. This often consumes much time and effort of people from different levels in the company. Too often, checklists are difficult to draw up and maintain. How to conduct this type of analysis in a precise manner is the object of a vast number of works, and is beyond the scope of this paper. We refer the interested reader to Grant (2002, ch. 5).

The second step of the analysis concerns the proper appraisal of internal capacities, acquired, maintained, developed or even discarded. Outsourcing is often the result of a firm's recognition of its limits in terms of flexibility, control and competencies, as well as costs incurred by internal bureaucracies in a reinvestment context. This type of analysis is especially difficult to manage, since internal departments tend to exert pressure to continue their own activity at the expense of (sometimes) more efficient external providers. As Doig *et al*. (2001, p. 33) report: 'managers often don't know — sometimes because they don't want to — how their companies really stack up against the best-in-class providers.' We advise that any cost analysis should be based not only on current performance of internal services, but also their potential for improvement. Let us be reminded, however, that outsourcing is far from being a sure means of obtaining cost savings, if this were at all possible to measure[2]. The more reluctant managers are often convinced by economies of invested capital.

The third step should clarify the state of market offerings, which has thus far been a major impediment to a more extensive development of strategic outsourcing. The complexity of outsourcers' demands poses severe challenges for the potential service providers in the field of logistics outsourcing: 'customers' demands are outpacing the logistics providers' ability to meet them.'). These issues concern mainly the service provider (see Exhibit 4).

The fourth step refers to implementation issues. Keep in mind that managers in corporate headquarters should be able both to conduct negotiations for large-scale contracts and provide guidelines for their businesses. In particular, they should able to provide framework contracts to ensure a high level of consistency and cohesiveness in their organisations. Such framework contracts generally include: the scope of services to be delivered, suppliers to be selected, pricing schemes to be followed, service levels and measurement, risks and liabilities, rewards, termination provisions and the consequences of termination. A thorough analysis of each of these provisions is beyond the scope of this paper (see Lacity and Hirschheim, 1993a, for a more complete view on this subject.) We simply underline the specificity of long-term outsourcing contracts over more constraining

Exhibit 4: Main Recommendations for Service Providers

The service provider must:

- ❖ agree to make a strong commitment and should have attained a critical size;
- ❖ be capable of assuming the investments stipulated in the sales offer;
- ❖ acquire or develop strong competencies in contract management;
- ❖ be able to make the offer evolve over time;
- ❖ guarantee that it can support its main clients in their future initiatives.

The service provider must also be equipped with performance measurement tools to ensure cost and knowledge transparency over time. It is important for the service provider to capitalise on experiences shared with clients, for by taking advantage of these shared experiences the vendor can help its clients learn. This implies the vendor must thoroughly understand the industrial processes of its main clients so that it can fully exploit all opportunities for service and productivity improvements.

To sell their services, competencies and experience, we recommend that, as suppliers identify new investment projects, they concentrate their sales efforts at both the operational and top management levels. This is because some business units are concerned about their efficiency and performance, and at the same time, the final decision to outsource seems to be rather centralised, meaning that they are made by top management.

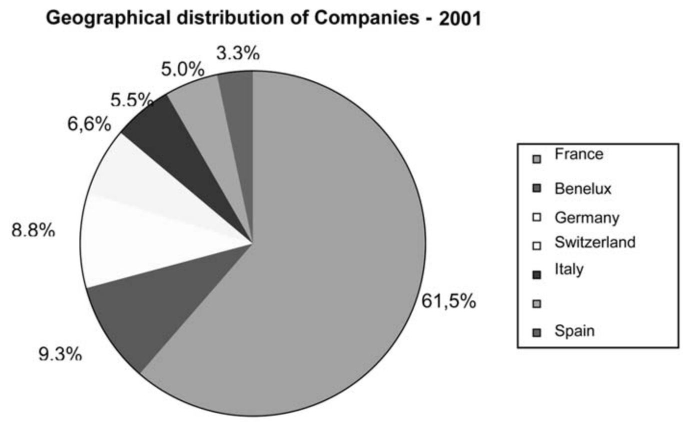
subcontracting contracts. Outsourcing contracts are more open to the vendor's initiatives, risks are shared in a more balanced way, trust and long-term commitment are developed with the vendor call for a different approach to implementing rewards and penalties, and termination clauses must be seen from the onset of negotiations due to the complexity of the operations involved.

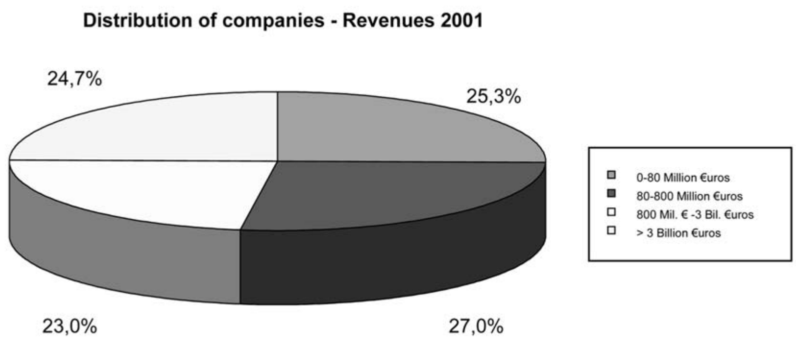
Finally, corporate managers are encouraged to adopt a portfolio approach to their outsourcing operations, balancing riskier investments with the lower risk, lower profitability ones. This portfolio approach should serve as a tool for categorising investments, helping top management to define clear priorities and control present and future investments, taking into account the company as a whole.

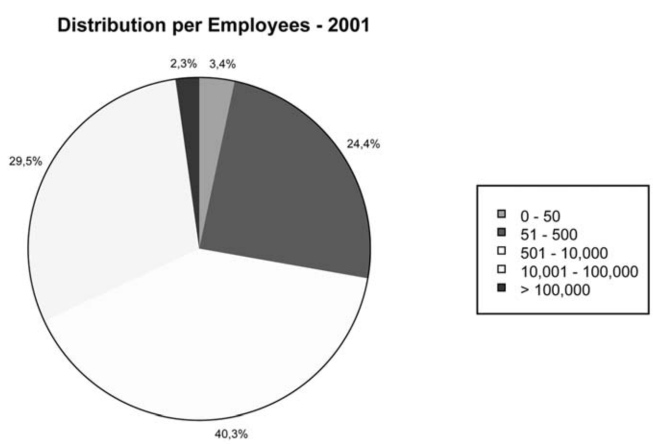
In our study, we identified the renewal of large-scale industrial investments as a very significant driver in outsourcing decisions. We highlighted the specificity of outsourcing at the corporate level. These managers attribute a distinct importance to the cost of capital and concern about core competencies, the two are inextricably linked. We also identified the main risks that management perceive to be associated with outsourcing, particularly the risk of loss of competencies, which companies must learn to mitigate through relevant monitoring structures. Outsourcing is thus inseparable from the management of knowledge, especially external knowledge. The capability to reap learning benefits from outsourcing, and not just gaining access to knowledge, entails the capacity to train and retain a relatively low number of highly skilled key employees.

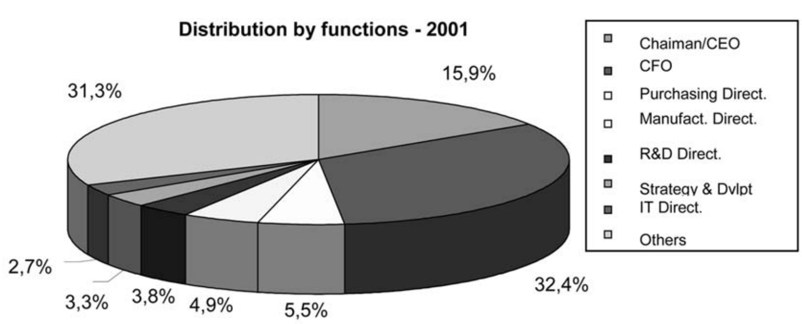
As business contexts today change rapidly, firms need increasingly to consider the long-term effects of outsourcing. The question of performance through outsourcing remains an open one (Poppo and Zenger, 1998; Leiblein *et al*., 2002). Indeed, a clear view of the objectives and risks involved are prerequisites to constructing adequate performance measurements. In increasingly competitive environments that exert pressure on firms to create value if managed strategically, outsourcing can be a choice that helps them gain a competitive advantage and ensure their future growth.

Appendix


Geographical distribution of Companies - 2001
5.0%
3.3%
5.5%
6,6%
8.8%
9.3%
61,5%
France
Benelux
Germany
Switzerland
Italy
Spain


Distribution of companies - Revenues 2001
24,7%
25,3%
23,0%
27,0%
0-80 Million €uros
80-800 Million €uros
800 Mil. € -3 Bil. €uros
> 3 Billion €uros


Distribution per Employees - 2001
2,3%
3,4%
24,4%
29,5%
40,3%
0 - 50
51 - 500
501 - 10,000
10,001 - 100,000
> 100,000


Distribution by functions - 2001
31,3%
15,9%
2,7%
3,3%
3,8%
4,9%
5,5%
32,4%
Chaiman/CEO
CFO
Purchasing Direct.
Manufact. Direct.
R&D Direct.
Strategy & Dvlpt
IT Direct.
Others

Notes

1. In this article, we will limit the study of organisational forms in outsourcing to vertical relational contracts. While there may be other forms of vertical disintegration, alliances are not considered here, nor are other more arm's length agreements, such as purchasing services on the basis of short-term spot contracts.
2. The more reluctant managers, though, are often convinced by economies in invested capital.

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