Management Update: Build a Solid Sourcing Business Case

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Link the Business and IT Strategies

The outsourcing business case is often formulated just before the contract is signed, and it is based on the service provider’s proposal, which focuses on short-term gains. Most of those business cases fail to address the essential link to the business and IT strategies of the enterprise.

That link is established in an effective business case — one that builds on a solid sourcing strategy and presents alternative scenarios that realistically assess potential future outcomes. Those scenarios should present not only potential cost savings, but also “soft benefits,” such as the ability to implement new strategies and products faster and more reliably.

Envisioning the future in the sourcing strategy phase is key. It will determine 80 percent of the success of the final outcome. It will push service providers to provide better and more innovative solutions that fit the enterprise’s strategic goals, which will ultimately help to build a more beneficial long-term relationship.

Anatomy of a Sourcing Business Case

Strategic Planning Assumption: By 2007, more than 80 percent of sourcing decisions affecting IT services will be made at a business level — under the authority of the enterprise’s board or business unit management — as part of business transformation or business process outsourcing decisions (0.7 probability).

Tactical Guideline: The sourcing business case should be developed as an integral part of the sourcing strategy.

The sourcing strategy development process begins with a “gap analysis” assessment of how the company is performing, based on four core questions:
• Are we doing the right things?
• Are we doing those things well?
• Are we able to achieve our short- and long-term business objectives?
• Are we able to react quickly enough to unexpected business challenges?

Next, the enterprise should conduct a market scan of the capabilities of external providers, develop alternative sourcing scenarios, and evaluate how the different scenarios answer the problem defined by the gap analysis. All this boils down to one or two sourcing scenarios that best fit the enterprise’s future needs. For those scenarios, a business case can be built to support the final decision on the strategy.

The development of the sourcing business case starts with identifying the type of relationship required to fulfill the enterprise’s strategic goals. Gartner has defined three main types of sourcing relationships (see Figure 1), based on the strategic objectives sought in the engagement:

**Figure 1**

Three Types of Sourcing Relationships

- **Utility relationship.** This type focuses primarily on IT cost control and, over time, cost reduction, with the goal of maintaining consistency in service delivery. Utility relationships generally involve large volumes of repetitive transactions, and typically become a commodity in the market.

- **Enhancement relationship.** This type is based on business productivity improvement. Although enhancement relationships often involve large-volume, repetitive transactions, the key difference is the goal, which is to make the service recipient more competitive by improving its
performance relative to the rest of the market, resulting in advancement toward predetermined business goals.

- **Transformation relationship.** This type is characterized by a partnership between the service recipient and provider that is focused on innovation and new business, transforming the manner in which an enterprise competes. The transformation deal typically focuses on business growth and revenue generation, in contrast to the typical cost reduction focus of a utility deal.

**Action Item:** Ensure that the sourcing business case is linked back to the overarching strategic business and IT objectives of the enterprise.

**Structure of the Documented Business Case**

**Tactical Guideline:** The sourcing business case should adhere to the corporate standards that apply to an executive-level business audience.

The main components of a sourcing business case address tangible costs and benefits, intangible benefits, and intangible risks. The documented business case typically includes the following sections:

- **Executive Summary.** This section provides management with a “snapshot” overview of the business case. It must be sufficiently clear and concise for executive management to digest it in a short reading or presentation.

- **Background.** This describes the situation that has created the need to investigate alternative sourcing.

- **Project Description.** This section describes the scope and objectives of the project and demonstrates how it will address the drivers discussed in the background section.

- **Proposed-Solution Scenario.** The recommended solution is described, along with an explanation of how and why it is the preferred solution for addressing the issues and drivers identified in the background section. Benefits of this scenario are detailed.

- **Alternative Scenarios.** Other solution scenarios are discussed, including the pros and cons of each.

- **Costs and Benefits.** This section should include an estimate for every anticipated cost for each scenario. Tangible and intangible benefits of each scenario are described here as well.

- **Implementation.** A high-level implementation plan is provided.

- **Assumptions and Risks.** Key assumptions that impact the costs and benefits of each solution are stated. Risks are identified for each solution, by impact and probability.

**Tangible Costs**

Each sourcing business case starts with the cost projections for the coming year. In calculating the costs, the following components should be considered:

- **Ongoing costs:** Operation fees of the service provider and the cost of the client team.
- **Transition costs**: The costs associated with moving to the service provider’s delivery and relationship model, including technology or connectivity setup costs. Plan for the transition period to last up to six months, if not more.

- **Transformation costs**: This area focuses on major business and IT changes to be implemented via the sourcing relationship, delivered through the service provider’s delivery model. Plan for the transformation period to last up to two years.

- **Transfer costs**: This cost area focuses on all ownership issues. It relates directly to due diligence issues regarding staff, contracts and assets (requirements to be managed on the balance sheet). Project up to three months or more.

- **Client sourcing program cost**: Costs associated with external advice on sourcing — for example, from legal, human resources (HR) and sourcing consultants — can amount to 1 percent to 2 percent of the total deal value.

**Intangibles**

Accurate communication of the contribution of IT to business success has become essential. A series of technically focused charts will do little to inspire confidence. It is important to express all performance measurements in business terms.

Also critical is to communicate how the proposed sourcing scenario will constitute a “good deal” for both parties over the long term. That means addressing four high-level areas:

- **Alignment and Vision**: Can both parties meet their strategic and operational goals, and respond to business and technology changes?

- **Contract and Relationship**: Will the management of the contract and the relationship meet the needs of both parties?

- **Customer Satisfaction**: Will business unit users and managers satisfied?

- **Service Level and Pricing**: Will the proposed scope of work, delivered service and price meet business requirements, and are they reasonable?

Enterprises must understand the mix of factors and behaviors that constitute a good deal for them and for their suppliers. To ensure that the deal stays on track, all the factors need to be regularly assessed. Too often, assessments focus on service levels and price alone and assume that the other factors will take care of themselves.

**Assessing Risk**

**Tactical Guideline**: Most business cases do not address key risks effectively. Risks should be quantified and prioritized, and mitigation actions and plans should be suggested.

In the insurance industry, an underwriter has to be convinced that the total risk is understood, quantified and manageable. The same holds true for risks for each of the sourcing scenarios.

Risks can be classified as economic, technical or business-related:

- An economic risk might be unexpected costs due to a hastily negotiated contract.
A technical risk might be the inability to reconcile in-house technical standards for retained services to the outsourcer’s architecture.

Business risks include unexpected changes to the business, and an inability to switch providers to meet new requirements.

The risk assessment process involves the identification of risks, the prioritization of these risks and the development of mitigation strategies. The risk assessment team should be composed of financial, technical, business unit, HR and legal representatives.

Facilitated brainstorming sessions can help identify the initial list of risks, which can be winnowed down through subsequent analysis. The risks are then assessed by impact and probability, which determines their priority. The last step in the process is to develop mitigation strategies for the risks of medium-to-high impact and probability.

In some cases, the return on investment (ROI) analysis is adjusted based on the outcomes of the risk assessment by applying a percentage — derived from the projected risk probability and impact — to the ROI figures. If such risk-adjusted financial analysis is considered too subjective or controversial, however, the business case can simply depict the results of the risk analysis in a stand-alone table for consideration.

**Bottom Line**

- Begin preparing the business case early. Chief financial officers will demand a business case to justify outsourcing. The business case should be started early in the sourcing initiative to guide the strategy and decision-making process.

- Let the strategic goals determine the type of sourcing arrangement used. Sourcing endeavors are determined by the goals and objectives of the business. For example, if the business seeks to reduce operational and IT costs and improve service, a “utility” deal is appropriate.

- Focus on tangible benefits, but do not ignore the intangibles. Widen the analysis to include intangible benefits, but ensure that a view without intangibles is also provided.

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This article is an excerpt of a chapter from a new report, “Successful IT Outsourcing: Strategies, Tactics and Management Approaches for Effective Strategic Sourcing.” The report is an offering of the Gartner Executive Report Series, a new business venture of Gartner Press that provides buyers with comprehensive guides to today’s hottest IT topics. For information about buying the report or others in the Executive Report Series, go to www.gartner.com/executivereports.

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- “CIO Alert: U.S. Offshore Outsourcing Leads to Structural Changes and Big Impact,” (IGG-07232003-01)

- “Management Update: The Road to Successful HR Business Process Outsourcing,” (IGG-07162003-02)