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## Outsourcing ROI

Key elements and benchmarks for obtaining maximum ROI

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**By**

For some, outsourcing is a controversial issue; but for many C-level executives in the manufacturing sector, outsourcing has been a strategic weapon capable of significantly improving operational and financial performance, as well as increasing shareholder value. This article presents an independent view and analysis of the economic value created and ROI achieved by manufacturing companies through outsourcing. It also includes benchmarks from a research study conducted by Glomark-Governan on the economic benefits that manufacturing companies have achieved with outsourcing.

### **A Partnership Approach: Key for Achieving World-Class Outsourcing Economic Benefits**

The benefits of outsourcing are widely recognized. EDS, who many credit as the pioneer for popularizing the use of the term "Outsourcing" several decades ago, used outsourcing to describe their service to run and maintain large mainframe computers and data centers. The initial outsourcing deals were multi-million dollar contracts which required an economic justification with a compelling business case.

Today, the term outsourcing is used broadly and encompasses many types of services. From offshore labor, to partial outsourcing (e.g., outsourcing an asset), to business process outsourcing (BPO); all the way to what some call full outsourcing, which includes the complete outsourcing of assets, people, business processes, and management of an area of the enterprise, all under the same contract. In theory, all types of outsourcing generate savings and economic value for corporations, however, there are substantial risks associated with outsourcing. Namely, when outsourcing is not managed properly and performance expectations are not properly defined between the provider and the buyer, the results can lead to a low ROI, or even failure.

To mitigate this risk, a new trend towards performance-based outsourcing, which transcends traditional SLAs, has evolved. These performance-based Outsourcing partnership agreements clearly define financial penalties or rewards for not meeting or exceeding agreed upon metrics. "Typically these type of partnerships, whether it's IT or maintenance, are performance-based, meaning the outsourcing partner projects additional financial value to be gained by applying world-class processes, technologies, and capabilities, and then contractually commits to this additional value. If the projected value is exceeded, that means more financial value accrues to the customer, and the partner receives a bonus. Conversely, if projected value is not achieved, the partner gives money back in the form of reduced margins," says Dave Biros, Director of Reliability Services, North America for ABB, one of the world's leading engineering companies.

The outsourcing of certain tasks to other countries (e.g. offshoring), while controversial, often provides significant cost savings to corporations. However, with the recent increase in wages in India, Asia and South America, the economic benefits of offshoring are yielding less attractive returns for some companies in first-world countries. Nonetheless, with the shortage of certain skills in first-world countries, many companies still see the value of offshore outsourcing, merely as a means of survival.

### **Achieved Benefits and ROI of Outsourcing**

The most common economic benefits achieved from all types of outsourcing are cost reductions. However, with BPO and full outsourcing, financial managers recognize that better cash flow represents one of the most attractive benefits of Outsourcing, as companies are not required to make large upfront investments in assets and business processes (e.g., considerable implementation expenses).

In a recent outsourcing research study, Glomark-Governan learned that Compania Minera, a metallurgic company in South America, found that an initiative related to inventory planning and management, if implemented and managed internally, would have resulted in a total cost of \$1.1 million per year, generating a rate-of-return of 61%. As a result, the decision was made to outsource the initiative to a leading outsourcing provider, who agreed to a performance-based deal that leveraged the outsourcing company's expertise and economies of scale. The outsourcing result: over \$1 million of additional business benefits, including increased accuracy of materials and reduced cycle-times, representing a rate-of-return of 231%. The total cumulative positive cash flow in two years for implementing the initiative internally for Compania Minera would have been \$1.7 million, versus the \$2.8 million that they achieved by outsourcing the initiative. In this example, a performance-based outsourcing agreement represented a better financial decision according to the spokesperson from Compania Minera.

Outsourcing providers also have well documented benefits from the results of Outsourcing contracts with their customers. "One example is the Carter Holt Harvey paper mill in Kinleith, New Zealand, which achieved a 17.5% increase in Overall Equipment Effectiveness and a 21% reduction in maintenance costs in a four-year time period, with the ABB Service," said Dave Biros, Director of Reliability Services, North America for ABB.

However, management's level of commitment always plays a key role in achieving results. "The lack of a clear business case, consensus among the management team, and a committed executive sponsor can cause an outsourcing project to fail," says Steve Cooper, Partner at Strativest, a technology strategy consulting firm, and former CIO of the American Red Cross and the Homeland Security Department. "If some executives want to save money in the long run, while others feel the primary motivation is to meet seasonal demands, then someone will be disappointed a year later. An involved and committed executive sponsor that really believes in owning the results is critical for achieving economic benefits and ROI from an outsourcing initiative," Cooper explains.

The recent Glomark-Governan research study on the benefits and risk of outsourcing identified a series of actual improvements that have already been achieved with various types of outsourcing. A sampling of these improvements, which can be used as benchmarks, includes:

### **IT Outsourcing Benchmarks**

- IT Total Headcount Reduction: 12% to 62%
- Application Development Budget: 11% to 21%
- IT Infrastructure Operational Cost: 16% to 48%
- Overall IT Operations Costs: 21% to 55%

### **General Business Process Outsourcing Benchmarks**

- Reduction in Business Process Costs: 6% to 41%
- Increase in Revenue: 0% to 7%
- Increased Customer Retention: 2% to 23%

### **Manufacturing and Maintenance Operations Outsourcing Benchmarks**

- Reduced Maintenance Costs: 15% to 30%
- Increase in Equipment Efficiency: 5% to 19%
- Reduced Inventory Level: 13% to 38%

### **Final Remarks**

In the most likely case, outsourcing will result in a positive impact on the bottom line of any company. In fact, many well-documented benchmarks (such as those listed above) exist today, which support the projections for forecasted improvements prior to making an outsourcing decision. However, in order to minimize the risk of failure, or of achieving a low ROI, a performance-based partnership agreement with outsourcing providers, and a committed executive sponsor, must be established, as it will increase a company's chances for economic success.

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