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How Multi-Sourcing, Cloud and RPA Impact End-of-Contract Choices

PETER IANNONE, ISG, AND
NICHOLAS SMITH, MILBANK

EXECUTIVE SUMMARY

The end of a contract term for outsourced services signals a critical decision point. Buyers have essentially four choices: (1) Renew the existing agreement; (2) Renegotiate terms; (3) Seek a new partner through a re-bid; or (4) Take services back in-house. Historically, renewal was chosen more than 90 percent of the time, largely because of the cost, complexity and operational risk associated with change.

The scale of the typical outsourcing contract contributed to this inertia – outsourcing contracts were large, multi-year agreements that were reviewed every few years. While the dollar amounts involved were substantial, in most cases the review process was relatively predictable: Unless the relationship was clearly dysfunctional, renewal or renegotiation (with some degree of adjustment in terms or pricing) was the common course of action.

Today, a number of factors are changing this dynamic and significantly raising the stakes for businesses. For one thing, multi-vendor arrangements, coupled with a long-term trend toward smaller and shorter-term agreements, mean that end-of-contract decisions must be made on an ongoing basis. Perhaps more importantly, a rapidly moving technology landscape, characterized by ongoing innovation and increasingly specialized service providers, puts buyers at risk of either missing out on critical emerging capabilities, or making the wrong choice when selecting a supplier.

This white paper, co-authored by an ISG Managing Director and a Millbank Partner specializing in outsourcing agreements, examines recent market trends and how they affect buyers and providers as they approach end-of-contract decisions. Specifically, the authors describe the implications of multi-sourcing, cloud computing and Robotic Process Automation (RPA), focusing on considerations from both a sourcing strategy and a legal perspective.

MULTI-SOURCING

Over the past 10 to 15 years, a landscape dominated by long-term, billion-dollar contracts with sole source providers has given way to multi-vendor agreements, smaller contracts and shorter contract terms and a more varied supplier market. Ongoing technology innovation has driven a wide range of new capabilities and solution options from a growing number of suppliers. In this environment, managing outsourcing relationship has become an increasingly complex endeavor, particularly in terms of end-of-contract decisions.

From a practical standpoint, the trend towards multi-sourcing means that end-of-contract decisions are an ongoing fact of life.

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With new agreements to implement and new providers to integrate into the delivery model, enterprises must constantly manage multiple moving parts and evaluate numerous options and alternatives.

Strategy Considerations

Effective benchmarking of existing operations and potential new solutions is imperative in today's dynamic environment. A benchmark establishes a baseline of the current state, and quantifies the potential opportunity to be gained by a new solution. This enables an enterprise to not only gain its bearings on where it stands, but to define a desired future state as well as chart an optimal path to get there.

Recent methodological developments have significantly enhanced benchmarking capabilities in terms of speed, cost and analytical scope. The process of data collection – which historically relied on painstaking manual entry and spreadsheets – is now automated and can be done essentially in real time. In addition, traditional benchmarks provided point-in-time historical snapshots of past performance. Today, advances in heuristics enable benchmarks to deliver forward-looking projections of how market trends and new technologies will impact pricing in, say, six to 12 months.

As a result, benchmarks are becoming increasingly relevant to operational strategies aimed not only at improving existing operations, but at assessing new technologies, modelling future scenarios and designing, implementing and managing operational transformation.

Another key to managing a multi-sourcing model is to ensure that effective processes and methodologies are in place around transitioning in new providers. The transition period is critical to the success of any outsourcing relationship, and while a successful transition lays a foundation for an effective partnership, an ill-planned and poorly executed transition undermines the new operation from the outset.

Finally, effective decision-making on sourcing options requires insight into provider capabilities, including not only the "usual suspects" of tier one outsourcers, but of niche providers and new entrants specializing in emerging technologies. With industry expertise becoming increasingly important in many sectors, clients must ensure that providers have relevant experience and can demonstrate an understanding of key business issues.

Legal/Contractual Considerations

Contracts have increased in length and complexity despite shrinking transaction scope, spend and term. This reflects both (1) an increase in the sophistication of buyers who are becoming more precise in their requirements for individual suppliers as the customer takes on greater responsibility as the de facto service integrator across a multi-sourced environment and (2) increasing regulation affecting the outsourcing sector, particularly in the areas of data protection and cybersecurity.

Careful consideration must be given to the type and amount of cooperation and information exchange that will be required across a multi-supplier environment. New contractual approaches and pragmatic views about what's required at an operational level are driving changes in traditional outsourcing contract approaches to governance, service levels and other service quality metrics and confidentiality.

As delivery models continue to evolve and take on new forms, flexibility in contracting and tight alignment between business and legal stakeholders is imperative. For example, even though the fundamental point is to have a company use software to perform a business function, there is wide variation in the documentation and economic/risk profiles of licensing locally-hosted software, versus having a service provider host the software as part of a bespoke service, versus a SaaS offering, versus a model blending bespoke elements with cloud components and automated processes.

CLOUD COMPUTING

New cloud offerings can deliver major benefits to infrastructure management in terms of cost savings, labor requirements and agility. Clients can leverage purchasing power, avoid lock-in with one provider and offload day-to-day management responsibility of multiple providers.

Today, most if not all of the major US- and India-based outsourcing providers have developed a healthy menu of hybrid, private and public cloud offerings. Brokerage services have matured, enabling clients to use third-party outsourcing providers to procure on-demand public cloud offerings and oversee and manage commercial, operational and technical requirements.

Hybrid cloud solutions offer a potentially less disruptive cloud option, enabling clients to use existing service providers and leverage infrastructure investments to take advantage of agile PaaS and IaaS for growth or specific applications.

Sourcing Strategy Perspective

Cloud opportunities needn't be restricted to the end of a contract period. A mid-term "health check" on a relationship can ensure that providers are driving innovation and not sitting on legacy infrastructure associated with high management costs.

To effectively explore cloud options, scope and requirements need to be documented for all applications and services being considered for a transition to a cloud-based model. The requirements should include, among other things, an overview of the business process, users (and their roles and responsibilities), interactions with other systems, availability, security, applications usage and growth.

One key question in assessing cloud is whether to work with an incumbent or seek a new provider. The former approach makes sense when the incumbent's contract allows the customer to take advantage of cloud offerings. Many agreements contain innovation or tech refresh clauses that can provide a window of opportunity to assess possibilities.

Other agreements, however, are structured so that the introduction of innovation may reduce resource requirements and negatively impact provider revenues. In such cases incumbents may be reluctant to proactively drive innovation. That said, a decision to move to a new provider should be taken as part of a comprehensive supplier evaluation that is undertaken for any type of service offering. The potential impact of migration and change should not be underestimated, and should be a critical criterion in the decision-making process.

In terms of benchmarking against an existing solution, cloud solutions are nothing more than a different deployment model for a set of applications and services. As such, comparisons can be made to evaluate criteria such as cost, flexibility, performance and scalability.

Legal/Contractual Considerations

From a legal/contracting perspective, data protection and cybersecurity issues are front and center at the moment. While many SaaS providers have become more sensitive and sophisticated on data protection issues in recent years, there still is strong resistance to agreeing to robust customer remedies for service failures, or to granting customers audit rights.

This continuing resistance by SaaS providers is particularly difficult to address in heavily regulated industries. For example, financial institutions are subject to regulations relating to data protection as well as regulations requiring financial institutions to engage in third-party risk management that goes far beyond what many outsourcing service providers (let alone SaaS providers!) are historically comfortable with, such as the customer having rights to audit not only the service provider but also the service provider's subcontractors.

Regulated companies are starting to use cloud-based solutions, but in limited ways that often are quite creative in finding ways to capture some of the economic benefit of cloud services without creating regulatory exposure.

SaaS providers continue to drive a very hard bargain on liability, with service level credits often serving as liquidated damages for service level breaches, and very low limitations on service provider liability for other sorts of breaches of the SaaS agreement.

As cloud services become increasingly pervasive, this typical SaaS approach to liability exacerbates the customer's risk as the de facto service integrator of a multi-sourced environment.

Despite the risk that comes with less customer-friendly terms in SaaS agreements, SaaS providers continue to compete for and win increasingly large engagements. This does not, however, mean that bespoke services are exiting the industry. Quite to the contrary, we are seeing an increasing amount of highly customized services that essentially are management services wrappers that provide the administrative oversight and service coordination between cloud-based services.

RPA

Robotic Process Automation (RPA) is emerging as an industry game-changer, offering client enterprises opportunities to dramatically reduce costs by implementing digital robots to execute routine and repetitive tasks traditionally performed by humans. In addition to cost savings, the enhanced accuracy and auditability of RPA solutions enables significant improvement in areas such as data analytics and regulatory compliance. At the same time, choosing among a wide range of RPA providers and myriad delivery models presents a significant challenge.

Sourcing Strategy Perspective

For service providers, RPA represents both a threat and an opportunity. The threat is obvious, as RPA undermines the traditional model of labor arbitrage and, by lowering costs, results in decreased revenue. Innovative providers who seize the RPA opportunity, meanwhile, can win new business and increase margins by leveraging automation capabilities to improve their internal delivery efficiencies.

These market dynamics have significant implications for end-of-contract strategies. Today, a client nearing the end of a traditional IT services agreement has an ideal opportunity to take advantage of RPA technology. The incumbent provider, however, faces a serious dilemma, since proactively offering an RPA solution risks cannibalizing existing revenue, while proposing a renewal of existing services and terms opens the door to aggressive competitors seeking to gain market share through RPA.

One way to gauge an existing provider's commitment to innovation is to consider whether they proactively bring RPA solutions to the table, or whether they do so only when asked. That said, clients can also be proactive and take steps to create incentives for providers to encourage RPA innovation and compensate for lost revenue. These incentives can include a better margin that maintains profits, or an opportunity to recoup revenue through new gain-sharing initiatives. This approach creates a potential benefit for the client by facilitating engagement and commitment from the provider, as well as mitigating the risk involved in bringing in a new team.

A decision to re-compete services raises a whole new set of questions – the most basic being, which set of outsourcing providers to engage?

Clients should also consider the short- and long-term implications of their provider's RPA go-to-market strategy. Expertise in implementing off-the-shelf software from vendors such as Automation Anywhere, Blue Prism or IPsoft is important. Moreover, traditional service providers are aggressively developing their own automation platforms. Along with IBM's established Watson initiative, these include Wipro's Holmes, TCS' ROBO tools, Syntel's SyntBots, HCL's Dry Ice and Infosys' Mana. The features and capabilities of these solutions vary widely, and each approach has its respective strengths, weaknesses and risks, which clients must consider in the context of their specific requirements.

Another option is a do-it-yourself approach to RPA, whereby customers repatriate services from their outsourcing provider and automate them using tools purchased directly from an RPA software vendor. While insourcing and leveraging RPA offers the potential benefit of building a tailored solution, the investment needed to develop in-house RPA expertise will likely be significant.

RPA also requires significant changes to the RFX process and redefines pricing and delivery mechanisms as the business model evolves from FTEs to outcomes and from total deal size to optimized margins.

Legal/Contractual Perspective

Uncertainty surrounding the productivity and economic benefits of RPA solutions is causing many customers to move away from an all-in managed services solution and instead adopt an approach of licensing RPA software/tools.

However, the more moving parts there are in a single business initiative, the harder and more time consuming it becomes for the customer to set up and administer the solution. We expect that a key factor in determining RPA provider success over the long haul will be whether the provider has an attractive self-service option.

Industry understanding outside of software developers and sophisticated service providers is still in its early days, and only a few industries have adopted RPA in bulk (insurance most notably). We expect to see a few core contracting conventions to emerge in the coming months and years, but clear industry contracting conventions are still a work in progress. Initial focus on legal terms has centered on benchmarking rights to give early adopters comfort that they'll stay current with market price decreases.

SUMMARY

Under the best of circumstances, end-of-contract considerations present a difficult set of choices. Today, implications of sourcing decisions are becoming increasingly high-stakes, given intense market competition and the dramatic pace of technology innovation.

Enterprises that renew existing terms without conducting due diligence on alternatives and improvement opportunities will almost surely fall behind industry leaders. At the same time, making the wrong choice can result in disruption and benefits that fall short of expectation.

Keys to an effective end-of-contract sourcing strategy include a thorough assessment of existing operations, evaluation of alternatives and considerations of long-term impacts. In addition, a pro-active approach to legal issues and contracting is necessary to ensure that agreement terms remain aligned with changing delivery models.

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PETER IANNONE

MANAGING DIRECTOR, ISG

Peter's advisory and financial services experience helps major corporations evaluate, implement and optimize IT and business process outsourcing arrangements. His clients have included major banks, insurance companies, asset management firms and other financial institutions. He has negotiated major contracts for outsourcing transactions with a combined total contract value exceeding $15B.

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NICHOLAS SMITH
PARTNER, MILBANK

Nicholas advises companies on complex commercial transactions, including IT and business process outsourcing and technology development projects and strategic alliances. He has also advised on the technology aspects of numerous restructuring matters, often supporting client efforts to rationalize their technology strategy and operations in connection with M&A transactions, investments, and restructurings. Nicholas has been recognized as an outstanding US practitioner in Legal 500.

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