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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).