The Optimal Approach for Sole Source Outsourcing

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Nearly all outsourcings start with some measure of supplier competition, even if only short lived. The customer typically has some amount of interaction with multiple prospective suppliers before settling on one. That is where the paths of outsourcing customers may diverge. Some customers follow a competitive bidding process, obtaining commitments to price and business terms from multiple suppliers. Other customers go to substantive discussions with just one supplier. There may be a number of reasons for proceeding with just one supplier. Sometimes it is because of another complementary or reciprocal relationship between the parties. In other cases it may be due to the need to engage the supplier in complex solution definition. Whatever the reason, a customer choosing the sole sourcing path must be careful not to underestimate the importance of following a disciplined process. The price of poor execution may not only be higher transaction cost and delay, but also the risk of a deal poorly conceived, short-lived, and long-rued by all involved.

Common Mistakes in Sole Sourcing

Many sole source negotiations tend to drag on due to a lack of organization and a lack of competitive pressure. Customers mistakenly take a reactive approach, relying on the supplier to provide the needed process, due diligence and deal structure. They may even believe that this informal, seemingly more collaborative approach lends itself better to building a long term relationship with the supplier. Note, however, the customer in a sole source deal has less market data than in a competitive process where there are multiple proposals that the customer can compare. In addition, the supplier in a sole source deal will naturally be inclined to press its position longer than in a competitive process since it does not face the

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immediate threat of being "de-selected" from bidding. Consequently, the customer in a sole source deal has to be more, not less, prepared and must use a process that includes meaningful deadlines.

Get Organized

Know your objectives. The first step in getting organized is to establish your company's objectives for doing the deal, and their relative priority. This can be harder than it sounds. Different parts of your company may have different views of why the deal should be done, and perhaps whether the deal should be done at all. Uncertainty as to priorities can cause confusion and delay. Finally communicate the objectives to your team and to your management up front and periodically to ensure a continued focus on what is important. This will also help you detect any changes in your management's position.

Perform due diligence. You should carefully perform your own financial and operational due diligence of the in-scope functions. This includes documenting the in-scope functions, business processes, service levels, personnel, assets, licenses and other third party contracts. By performing this due diligence up front, you reduce the risk of uncertainty and doubt, accelerate the supplier's proposal process, and increase the supplier's confidence in the information and data it receives. Better information from the customer will reduce any "risk premium" that the supplier may feel compelled to add to its pricing to adjust for perceived faulty or incomplete information from the customer. The supplier should conduct its own due diligence anyway, but that due diligence will be to confirm the accuracy of your data.

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Establish a cost baseline. By establishing a projected cost baseline, you effectively create a competitor for the supplier. The projected cost baseline is the current customer cost for performing the in-scope function projected over the proposed term of the outsourcing arrangement. It should include the cost savings you realistically believe can be achieved. A common problem in baselining is that managers of the in-scope function take an aggressive view of the potential cost savings that can be achieved by the customer, oftentimes because they fail to account for the full costs or risks of implementing the requisite cost savings projects. This may be motivated in some cases by the natural desire of managers to demonstrate that they can do the job themselves, or to lead the supplier to provide lower price submissions. One way to help counteract this problem is to make clear to your managers that they will be held to their projections should the outsourcing not occur.

Control the Process

The supplier controls its solution and its responses to your requests, but you should control the process for interactions with the supplier. The process should be designed to ensure that: (1) communications are with parties that have appropriate authority and accountability; (2) there is agreement on basic deal terms before proceeding with detailed discussions; (3) the customer has a form of agreement that is protective of the customer, yet reflects market realities; (4) subject area specialists, such as HR, tax, and risk management, are engaged at the right junctures, and (5) appropriate inbound and outbound due diligence occurs.

Use a schedule and manage to key dates. You should establish a negotiation schedule that is aggressive yet realistic. Both the customer and supplier teams have to commit to complying with that schedule. You must then manage your internal processes and interactions with the supplier to the key milestone dates in that schedule. The schedule should include checkpoints at which the customer project team confirms its decisions with, and obtains directions from, management.

Place reasonable limits on negotiation sessions. Limit the number of sessions and length of sessions. This forces both teams to focus on what's important, and not spend time on issues of low value. Make sure you have the supplier's decision makers in the room. You should also include the supplier and customer managers who will be responsible for managing the relationship once the agreement is signed. Their involvement is critical to ensuring that the implementation teams have a clear understanding of the agreement terms and background intent. It also provides you with an excellent opportunity to assess the problem-solving skills of the supplier's manager who will be critical to the success of the outsourcing arrangement.

Use market terms. Start with a form of agreement that reflects market precedents that the supplier will recognize. Make sure the project team includes counsel and advisors who know market deals, have the experience to ensure your terms are competitive, and can provide with you alternative approaches to resolving supplier concerns. It is also important to take time to make sure that all members of the negotiating team understand the purposes of the various agreement provisions and their relative importance before you proceed in negotiations.

Negotiate big ticket items first. Tackle the largest, most difficult items first. Use a term sheet if necessary, so as to not waste time on issues of lesser importance, only to discover later that the parties cannot bridge a key issue. Understand which issues the supplier has less flexibility on early in the negotiations. Discuss those issues that matter the most to you with your counsel, and agree to yield on issues of lesser importance. For example, if ownership of developments is an issue, the customer may decide that ownership by the customer is not mandatory if sufficiently broad license rights can be obtained.

Require continuous improvement in positions. Use a process where Supplier must continually improve positions in between negotiation sessions, and handle all big items together. It is difficult to deal with most issues in isolation. However, require a linear process: once the parties have resolved an issue, it remains resolved. This requires careful tracking and documentation of open issues and agreements.

Maintain a sense of competition. You can maintain a sense of competition in two ways. The first is the prospect of changing to a competitive process. You can accomplish this by making clear to the supplier that you will re-evaluate whether to proceed on a sole source basis if the key milestones dates are not achieved. The second approach involves reminding the supplier that the customer is also a competitor. As mentioned above, with a carefully constructed baseline, the supplier is effectively required to compete with the in-house function itself. This competition can be also be formalized. In one case we have seen, the customer's final board approval process was explicitly designed to include competing presentations between advocates of retaining the function in-house and the outsourcing project team.

Negotiation is a two-way street. If you expect the supplier to come to each session prepared, then your project team must also be prepared to meet its commitments. That will require making sure that your project team has sufficient time, resources, and access to decision makers. You cannot reasonably expect the supplier to make progress on issues if your project team does not demonstrate a willingness and ability to do its part.

Know the Limits Without Sacrificing Key Protections

Be flexible. The number of the concessions that you could obtain in a competitive situation may not be achievable in a sole source negotiation. Be clear about what is most important to you in the deal, and remain flexible. An experienced counsel can advise you on fallback positions that can help resolve an impasse while preserving essential protections for you in the deal.

Have a backup plan and be prepared to execute it. Your commitment to the project schedule and the threat of competition are only going to be credible if you have other options. You should define these other options, and in the event the supplier fails to meet key dates or respond to your requirements, you should have the ability and the will to implement them. These options may include alternatives such as proceeding with an RFP for other suppliers, putting the project on hold, or proceeding with internal sourcing and cost savings projects. Retaining viable options requires planning and management endorsement. The supplier is unlikely to be persuaded that your options represent a real risk if your project team members do not believe it themselves.

Know when to cut your losses. Understand that after a certain period of time, if you have not moved the deal to the point where you can sign it and be satisfied, you might need to change course. After a reasonable schedule and a reasonable period of negotiations, if the parties are still far apart on important issues, it might be necessary to stop a process that is meandering, and get it back on track. This could happen by the customer deciding to go into lockdown for a short period to attempt to break through remaining issues, or by the customer taking a break from the negotiations to reset expectations and check on direction with management. It might also take the form of considering a competitive bid situation to bring the deal back to the terms that the customer is seeking.

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Preserve flexibility in the contract. In a sole source situation, it is essential that you preserve rights to flexibility and price protection in the contract. These rights include the ability to bring some of the functions back in-house, to use third parties for the same or similar services, to benchmark pricing and require pricing adjustments, and various other methods to preserve leverage after contract is signed. These provisions will help you to correct off-market provisions and solve performance problems if it turns out that you misjudged the market competitiveness of the supplier's pricing, solution, or capabilities. Contrary to some supplier assertions, relationships can be even stronger when the customer does not feel trapped by the contract, and has the ability throughout the term to go to the market and check the terms of the deal.

Conclusion

It can be tempting to view sole source outsourcing as a simpler and easier approach to outsourcing. It appears to require less internal time and effort; however, that is often not the case. Successful outsourcing deals, whether done in a competitive or a sole source context, require great planning and a great process. Success in a sole source outsourcing deal requires an additional measure of organization, control and effort.

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