



January 2007

## **RESTRUCTURING OUTSOURCING AGREEMENTS: AN INDICATION OF FAILURE, OR A TOOL TO INCREASE VALUE?**

### **Executive Summary**

The role of outsourcing as a primary vehicle to help corporations achieve a range of strategic objectives — from realigning corporate cost structures to acquiring new sources of human capital and to facilitate participation in the rising tide of globalization — is well documented. In recent years, this movement has led to a surge in outsourcing agreements, and — not surprisingly — to an accompanying rise in the tally of outsourcing agreements subsequently restructured or renegotiated.

While much is known about the popularity and success of outsourcing, substantially less has been brought to light about the inner workings of the renegotiation and restructuring process and the results that typify outsourcing. With the booming global economy unlikely to encourage a downshift in outsourcing renegotiation and restructuring anytime soon, TPI has targeted this area for further study, surveying dozens of companies in North America and Europe that revised their outsourcing agreements over the past decade to varied results.

This research report from TPI uncovered a number of interesting revelations about the nature of outsourcing and the reasons why companies often pursue renegotiation or restructuring as little as 18 months after signing their original agreements.

Among the survey's most striking insights, TPI found that overall satisfaction with outsourcing arrangements often lags expectations, with companies reporting that they receive — on average — only 72 percent of the value they had anticipated. This observation brings to the fore the seminal question of whether or not the participants — outsourcing clients and their service providers — are effectively aligning expectations in the course of designing their relationships. And, in the event of misalignment, how are the techniques of restructuring and renegotiation used effectively to remedy the variance?

Further, we found that dissatisfaction with outsourcing arrangements generally arose when clients expected more from their service providers than may have been realistic. (In hindsight, 52 percent of responding companies evaluated their expectations as unrealistic.) Industry experience reveals the complicated nature of designing outsourcing relationships that transcend mere pricing agreements to deliver increasing value to both participants over time. Might the rapid acceleration of outsourcing that occurred over the past several years have included a significant number of poorly constructed arrangements that are now revealing challenges in implementation?

TPI's survey respondents also pointed to insufficient corporate governance of their outsourcing agreements as another obstacle to success, with about 46 percent failing to fully implement proper governance structures and about 35 percent neglecting to convene regular meetings of their governance boards to review outsourcing issues. These self-admissions of deficient management attention to such an important and complicated corporate utility — outsourcing contract governance — is among the most revealing corollaries to the increasing tendency towards contract restructuring and renegotiations. The symptoms were generally left untreated by a large proportion of the companies sampled.

In addition, one in three companies participating in TPI's survey reported that their leverage at the bargaining table had lessened when renegotiating outsourcing contracts as compared with perceived leverage before signing their original outsourcing agreements.

When undertaken skillfully — or with the help of an experienced advisor — most outsourcing negotiation pitfalls may be avoided. In fact, this report shows that renegotiated outsourcing agreements often lead to improved contract terms, extended contract durations, higher satisfaction levels and stronger relationships between the client and the service provider.

**THE WISDOM OF OUTSOURCING... AND RESTRUCTURING**

In the summer of 2006, TPI surveyed 40 companies across diverse industries, gathering feedback on the enterprises' experiences in restructuring and renegotiating outsourcing contracts. The project aimed to determine the principal reasons for contract renegotiation and whether the results were satisfactory. TPI's findings showed that while companies' reasons for restructuring outsourcing contracts varied widely, few entered the renegotiation process because they were dissatisfied with the services they were receiving, and even fewer chose to exit outsourcing contracts entirely. In fact, a large number of respondents noted that, had they better managed their original contracts, they might not have had to revisit them. The majority believed that renegotiation, once pursued, generally pays off.

*While companies' reasons for restructuring outsourcing contracts varied widely, few entered the renegotiation process because they were dissatisfied with the services they were receiving.*

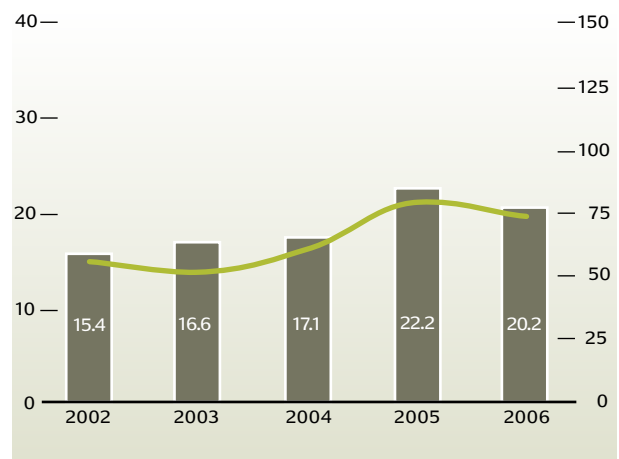
Some key points:

- Restructuring outsourcing contracts across industries is increasing significantly
- “Handshake” agreements — or agreements whose terms aren't carefully circumscribed in advance — have not lived up to expectations in many cases
- Restructuring typically occurs about three to six years into a relationship
  - ◆ Dynamic business conditions often force renegotiation of larger contracts in as little as 18 to 24 months after initial award
- Nearly 50 percent of respondents reported receiving at least 80 percent of anticipated value before renegotiating contracts

**EXHIBIT 1  
Survey Background and Objectives**

TPI surveyed 40 companies across multiple industries that have recently restructured or renegotiated outsourcing contracts in order to understand reasons why the process was undertaken and to capture key lessons from their experience. It should be noted that the companies surveyed did not necessarily utilize the expertise of TPI or another sourcing advisor for their original contracts or the subsequent renegotiations.

**Industrywide Contracts With TCV > US\$50M: Y/Y Restructuring Growth**



Types of outsourcing contracts surveyed:

- IT-full (5)
- IT infrastructure (15)
- IT-ADM (1)
- Human Resources (HR) (8)
- Multi-process (4)
- Other (5)

Cost savings and long-term efficiency benefits of external sourcing have prompted a broad cross section of companies to pursue outsourcing arrangements as a way of gaining a competitive edge in an increasingly challenging global marketplace. As a result, outsourcing relationships are becoming smaller, more numerous and more complex, with clients increasingly using multiple service providers.

Respondents to TPI's survey answered 30 questions about the breadth and depth of their outsourcing agreements, from how they were handled at the outset to how they were ultimately renegotiated. These inquiries seek to provide a clearer understanding of why outsourcing contracts may be restructured. Issues addressed included:

- The major reasons behind a company's decision to renegotiate a sourcing contract
- The alternatives considered (for examples, changing service providers and/or going back "in-house")
- Changes in the contract as a result of restructuring
- Lessons learned from the sourcing and restructuring process
- Whether goals were being met following restructuring

This research report summarizes the experiences of companies that have restructured outsourcing agreements, drawing lessons from real-life examples on how to best approach the renegotiation process for maximum value.

### REASONS FOR RESTRUCTURING

Companies are primarily motivated to renegotiate outsourcing contracts because of a fundamental change in their business, not because of service delivery problems with their service providers. Only a small subsection of respondents to TPI's survey reported dissatisfaction with the quality of services

they received. The reasons most often cited for restructuring by companies participating in the survey included:

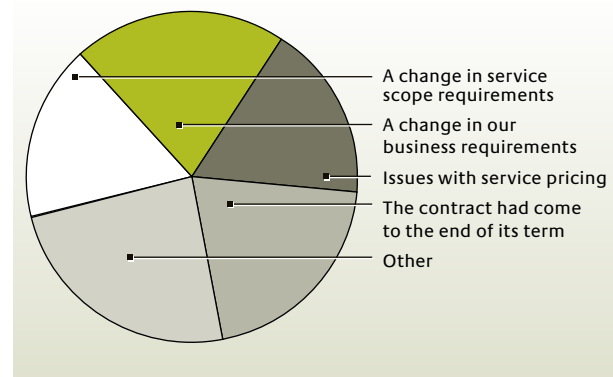
- A change in business volume
- A change in service scope
- Issues with service pricing
- The contract was revised after having expired

### EXHIBIT 2

#### Primary Reasons for Entering into Renegotiations

As depicted in the below graph, the two most frequently cited reasons for contract renegotiations were "contract came to end of term" and "change in business volume requirements."

#### Top Five Reasons Reported for Contract Renegotiations



Other reasons for renegotiation mentioned on a secondary basis included "issues with service quality," "issues with service relationship" and "desire to access new/different solutions."

Based on TPI's experience in advising clients on outsourcing agreements, trouble spots can often emerge as a result of:

- A large number of sole-source agreements, which can weaken a company's bargaining power
- The deferral of critical details in favor of an "executive handshake"
- Unrealistic client expectations of a customer-friendly agreement

### A Common Pitfall

**The Promise:** “A partnership with a premier service provider of world-class solutions”

**The Reality:** “Same staff delivering the same services”

### SOURCES OF DISAPPOINTMENT

Problems encountered with outsourcing contracts prior to renegotiation often stem from misunderstandings between the company and the service provider about the scope of services to be provided — again, not from the quality of services actually being rendered.

Companies cited their own lack of expertise in drafting the initial outsourcing agreements as a major impediment to a higher degree of success. This suggests companies might benefit from seeking the advice of an outside firm experienced in guiding clients through the complexities of the outsourcing process before entering into agreements. For example, essential assumptions must be aligned regarding whether or not the service provider will assume then-existing operations or — instead — accelerate the transformation of services through deployment of provider-defined solutions. This one point introduces far-reaching ramifications to the management of change across the enterprise and the setting of internal expectations.

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*Companies cited their own lack of expertise in drafting the initial outsourcing agreements as a major impediment to a higher degree of success.*

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Consider these representative comments from the companies surveyed by TPI on the divide that can emerge between what an outsourcing agreement seems to promise and the subsequent reality:

There was the broad expectation of BIFF (“big improvements for free”). In reality, the service provider will always give you NIFF (“nothing is for free”) and will only stretch toward excellence when challenged to do so.”

“I believe we largely underestimated the task of managing the contract and all that entails. It took us a few years to get the proper quantity of resources in place to tackle the job worldwide. Our largest disappointment before we renegotiated was our finding that our pricing was significantly higher than market.”

“We spend months on designing a contract, and ultimately it never covers every scenario that may come up. We invested a lot of time with the service provider arguing over the interpretation of many clauses, as situations inevitably arise that are not exactly as expected, but similar; and each party naturally interprets the gray area to its advantage.”

### AN EVOLUTIONARY PROCESS

Counter to what some might believe, the reconsideration of an outsourcing agreement is not so much an indication of a failure in the relationship as it is an opportunity to secure a better outcome for all involved. In fact, contract renegotiations are often obligatory simply to keep pace with developing

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*Companies blame themselves at least as much as the service providers for their own dissatisfaction with outsourcing relationships.*

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business trends — not because of any slip-ups on the part of the service provider. As a measure of this, less than one-fifth of the companies surveyed by TPI reported severing all or part of their relationships with their service providers. Furthermore, the data collected reveal that renegotiated contracts were often extended in length and scope when compared with previous arrangements.

Note these five insights observed by TPI in advising its clients, as reinforced by the survey data:

- Most outsourcing agreements will undergo a significant amount of restructuring before they expire
- A majority will be restructured within the first three to four years
- Roughly three-quarters of these agreements will be restructured with the incumbent service provider
- Most of the remainder will be re-sourced rather than insourced
- Only a fraction will be in such trouble that litigation is pursued

The need to restructure an outsourcing agreement should not be considered a failure in the relationship.

Interestingly, many companies blame themselves at least as much as the service providers for their own dissatisfaction with outsourcing relationships . This calls attention to the need for companies to proceed carefully in managing their outsourcing agreements, both in terms of expectations and execution.

**EXHIBIT 3**

**Analyses of Top Trouble Spots**

This table clearly shows how companies, by their own admission, often contribute to the conditions that eventually force them to revise an outsourcing contract. Note, in particular, the emphasis on setting up contracts versus actively managing them.

Statement	Agree Strongly	Agree	Disagree	Disagree Strongly
The problems were due to our organization placing more emphasis on setting up the contract than on managing it.	28%	33%	22%	17%
The problems were due to the service provider(s) failing to deliver on promises.	17%	36%	39%	8%
The problems were due to unrealistic expectations on the part of the service provider(s).	6%	31%	49%	14%
The problems were due to unrealistic expectations on the part of our organization.	9%	43%	34%	14%
The problems were due to inexperience in managing outsourcing contracts.	20%	29%	37%	14%

TPI’s experience in negotiating outsourcing agreements reinforces the observations reported by the sampled companies. That is, the art of successful outsourcing is less dependent upon strong contractual language than it is on the effective alignment of expectations among the parties. This requires skill and experience in navigating the nuances and semantics of outsourced services — and through installing a competency in service management and governance.

**Management of the Contract Prior to Restructuring**

With the critical importance of service management and governance in mind, it would behoove companies to pay more attention to the management of their outsourcing relationships, though it appears that many do attempt to track how well terms of their contracts are met in addition to convening governance meetings to evaluate progress.

Even so, the table below suggests that companies could do more to successfully manage their outsourcing agreements by discussing key issues more frequently with sourcing advisors.

**EXHIBIT 4**

**Client Areas of Focus In Managing Outsourcing Relationships**

Below companies indicated that their chief focal points in responding to the question, “Please select all of the following that applied to your organization’s management of its outsourcing contract before it was last renegotiated.”

Annual benchmarking of performance	40.5%
Regular review of the business case	54.1%
Regular referral to the contract	78.4%
Regular meetings of a governance board	64.9%
Regular consultation with sourcing advisors	32.4%
Full implementation of the governance structure and sourcing management framework outlined in the original contract	54.1%

While it is commonly accepted wisdom that the best contract is the one that is rarely referred to by necessity, the governance component of managing outsourcing agreements appears to be the most often-cited issue related to restructuring.

Perhaps this would not occur as frequently if companies relied more effectively on sources of practical expertise in managing the various elements of effective governance.

### Perception of Value

Companies tend to be satisfied with the value they receive from outsourcing contracts both before and after restructuring, according to TPI's survey. This underscores the positive results that may be gained from outsourcing, regardless of renegotiations (though these agreements do require frequent review and maintenance).

As touched on earlier, nearly half of survey respondents reported receiving at least 80 percent of the value they had initially expected prior to restructuring, with only a handful of companies giving extremely low grades to their service providers.

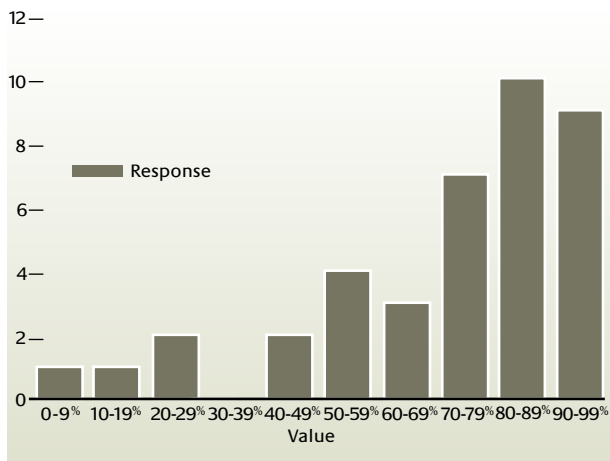
Demonstrating this, survey respondents indicated they were much more likely to renegotiate a contract due to internal changes to their own businesses (for example, a fluctuation in sales volume) than because of perceived shortcomings in the services provided.

### EXHIBIT 5

#### Value Expected vs. Value Perceived

Nearly 50 percent of respondents reported receiving at least 80 percent of anticipated value before renegotiating contracts.

25 percent reporting receiving less than 50 percent of anticipated value.



While substandard “value received” is often anecdotally reported as one of the main reasons for companies’ dissatisfaction with their outsourcing agreements, this table illustrates that this is generally not the case.

### Early Warning Signs

With the benefit of hindsight, 61 percent of respondents said there were warning signs of issues that would later require attention. When asked to elaborate, companies offered a number of analyses that, as often as not, boiled down to their own behavior when drafting or troubleshooting outsourcing agreements. Among their responses:

- “The original contract was not managed well. Metrics/SLAs had no flexibility and should have been changed.”
- “Certain key contract constructs were unclear or open to interpretation.”
- “Lack of willingness to negotiate on project pricing and inflexibility in delivery of services”
- “Lack of focus on generating business benefits for customer”
- “Our own growth and changing needs”
- “From the first day, there were discussions that included the phrase ‘not in scope’” — a reflection of what the contract would not be offering.”

### Alternatives Considered

There are three logical alternatives available once a company decides that contract restructuring is necessary:

- Re-tendering (switching to another service provider)
- Bringing the work back “in-house”
- Remaining with the incumbent service provider

Though 42 percent of TPI's survey respondents said that they considered soliciting bids from other service providers, only 18 percent actually did so. The option was not considered by forty percent. Similarly, 41 percent said they considered bringing some or all of their outsourced work back “in-house,” but only 13 percent actually followed through. The in-house option was dismissed outright by 46 percent of respondents.

While alternatives to the incumbent often appear attractive, in its own experience, TPI has found that the friction typically involved in making the switch can be quite considerable. Further, most clients conclude that the industry's service providers are generally adept at delivering to contractual commitments and that courses of remedy must necessarily involve changes to the service management and governance processes as a first course. Aborting an outsourcing arrangement is rarely considered a viable first option.

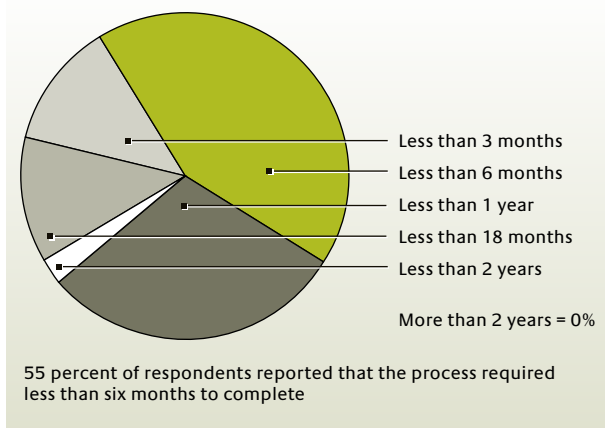
### The Restructuring Process

Although it frequently proves worthwhile, contract restructuring can be a complicated endeavor. TPI's survey explored the time necessary to complete renegotiations, as well as companies' perceived bargaining power and leverage during the renegotiation and/or contract renewal process. It also gauged the level of difficulty companies described in drafting new outsourcing pacts.

When asked about the duration of renegotiation, 85 percent of those surveyed indicated the restructuring process required less than a year to complete. Fifty-five percent finished renegotiations in less than six months and 13 percent finished in less than three months.

### EXHIBIT 6

#### Time Required to Renegotiate the Contract



When asked to evaluate their leverage at the negotiating table, 29 percent of respondents reported that their position during restructuring was weaker than at the time of the original contract's signing.

Offering a tip on how to boost leverage, one respondent who reported having gained the upper hand advised, "Parceling out the IT infrastructure into separate chunks and tendering for other components has provided significant leverage through the renegotiation process."

Feedback on the difficulty of the restructuring process was largely polarized. Forty percent of survey respondents said renegotiating was "very difficult," while 37 percent indicated that it was "fairly easy."

One company that described the task as "fairly easy" noted, "The process had to be rigorous and transparent in achieving value-for-money outcomes."

Based on these findings, as well as on TPI's own handling of contract renegotiations, the following template serves as a good guide for achieving optimal renegotiation results. Since every contract is different, this is meant to be used as a frame of reference only.

#### Phase I

Conduct assessment and develop a strategy 3 - 6 weeks

Plan for additional time if client leverage or issues are unclear

#### Phase II

Conduct good-faith negotiations with service provider 4 - 8 weeks

Allow additional time for service provider response if scope is large

Plan for additional time if outlook is promising but closure is not achieved

#### Phase III

Develop contract amendments 4 - 6 weeks

Timeframe depends on extent of changes

*Note: This is a boilerplate for driving discussions; actual activities and timing will be determined by scope, term, and severity of issues being addressed.*

Coming out of restructuring, 40 percent of respondents reported an increase in "expectations with regard to subsequent outsourcing agreements."

As companies increasingly acquaint themselves with the outsourcing and renegotiation process, finding new ways to achieve ever greater benefits, TPI expects the frequency of agreement restructurings to grow. Service providers should note that the bar is continually being raised on the quality of services they provide.

#### Major Changes Made to Renegotiated Contracts

Renegotiation often entails overhauling major components of the original agreement — including the price tag. The four most frequently targeted areas for change are:

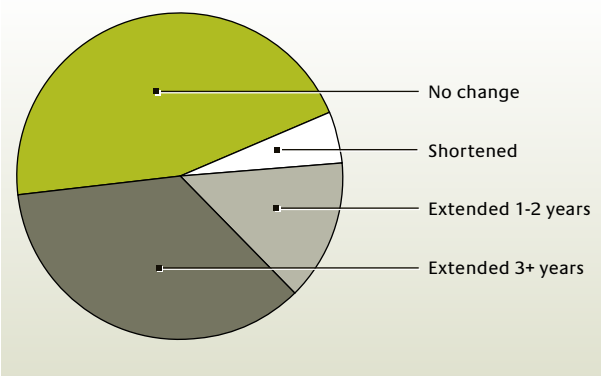
- Change in term
- Change in scope
- Change in contracted cost
- Change in satisfaction level

Contrary to popular belief, restructuring often leads to an extension in the duration of the outsourcing contract. In TPI's survey, 46 percent of respondents reported an increase in term, with contracts most frequently lasting three years and in excess of four. Forty-two percent of those surveyed reported no change in term, and only five percent reported a decrease.

**EXHIBIT 7**  
**Change in Contract Term After Restructuring**

Contrary to popular belief, restructuring frequently results in an extension of the contract relationship.

- 46 percent reported an extension in contract term
- 42 percent reported no change
- Only five percent reported a decrease in term



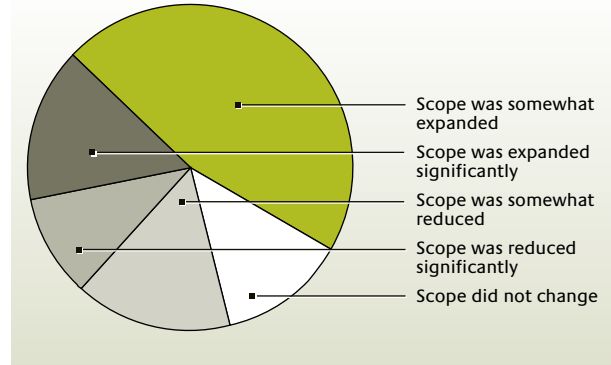
Most renegotiations also yielded an expansion in contract scope. Fifty-nine percent reported that their renegotiated contracts called for a broader range of services than their original agreements, with 13 percent citing a “significant increase” in the services provided.

About 26 percent reported a decrease in scope, with 10 percent citing a “significant decrease.”

**EXHIBIT 8**  
**Change in Scope**

Most restructurings yielded an increase in contract scope.

- 59 percent reported an increase in scope resulting from renegotiation (with 13 percent citing a “significant increase”)
- 26 percent reported a decrease in scope (with 10 percent citing a “significant decrease”)



The data from TPI's survey squarely supports the notion that restructuring need not reduce the breadth of services provided by a contract. Indeed, renegotiation may even improve the contract's value by offering additional services while lowering its overall cost.

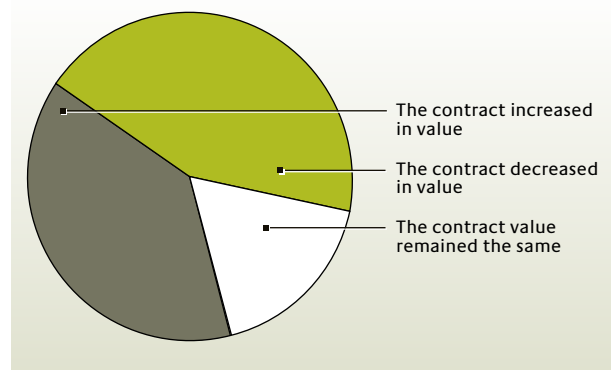
*Renegotiation may even improve the contract's value by offering additional services while lowering its overall cost.*

Still, a glance at changes in the price tags of restructured contracts surveyed by TPI shows mixed results on this front. Thirty-nine percent reported an increase in the cost of their renegotiated contract, while 44 percent reported a decrease.

**EXHIBIT 9**  
**Changes in Cost of Renegotiated Contracts**

Changes in contracted value post-renegotiation showed mixed results.

- 39 percent reported an increase in contract value as a result of renegotiation
- 44 percent reported a decrease in contract value



The greatest advantage for companies that engaged in renegotiation appeared to be the higher level of overall satisfaction they reported following restructuring. Before renegotiation, companies rated their satisfaction level at 6.2 on a scale of 1 to 10, with 10 being the highest level of satisfaction. After renegotiation, their average level of satisfaction rose to 7.8.

### Effectiveness of Changes

Of those surveyed, 56 percent indicated that renegotiating their outsourcing contracts proved “effective” or “very effective,” while 21 percent said it was “too early to tell” and five percent reported that their changes were “not effective.” This again offers evidence that engaging in renegotiation can yield impressive returns.

### Lessons Learned

Looking back on their outsourcing experiences, respondents to TPI’s survey said that they would have done a number of things differently prior to renegotiation for better results, including:

- “More detailed due diligence” and “better understanding of business requirements to support pricing”
- “Enact a governance process and stick to it”
- “Maintain resources and commitment in ongoing management of the contract”

### The Governance Cornerstone

Over the course of several hundred client agreements, TPI has observed one key point that was repeatedly backed by its survey findings: The manner in which an outsourcing relationship is managed can be at least as important as the attention given to forging the outsourcing relationship.

Too often, a company will take a “turnkey” approach to an outsourcing agreement, expecting the service provider to address all important issues independently and to anticipate the need for operational metrics in gauging value. In truth, meaningful metrics cannot be separated from the client’s business strategy. Indeed, the only way to benchmark value is through careful, persistent attention to detail by all parties involved.

The results of TPI’s survey bear this out. According to its data, 89 percent of respondents either agreed or strongly agreed with the statement, “The problems (with contracts) were due to our organization placing more emphasis on setting up the contract than on managing it.”

Similarly, 69 percent of respondents either agreed or strongly agreed with the statement, “The problems were due to inexperience of managing outsourcing contracts.”

Good governance of an outsourcing relationship can take on several forms, but all of them require the active participation of the company that is retaining the services. For best results, it would behoove companies engaged in outsourcing agreements to:

- Ensure that operational metrics accurately reflect the changing requirements of the business
- Cooperate with the service provider in considering deployment of new technologies to maximize value and minimize risk
- Monitor productivity and quality of applications development
- Analyze critical service levels and key measurements to confirm that credits for services are properly accounted for
- Devote appropriate executive attention to escalation protocol, with timely resolution plans

Though 65 percent of our respondents reported “holding regular meetings of a governance board,” merely having a board that meets occasionally is not enough. Retaining an outsourcing advisor can often reap dividends, as does keeping open the lines of communication between the outsourcing client and the service provider. Again, the frequency with which companies cite their own organization as too lax in supervising their own agreements underscores the need for tighter governance.

### Conclusions

The survey data supports observations from TPI’s own experiences in advising clients engaged in outsourcing agreements. Among them:

- Restructuring is, in many cases, a natural evolution of a relationship — not an indication of failure.
- Time spent working on the design of the requirements-definition phase of a contract often pays off later.
- As in “lean manufacturing,” \$1 spent on design may yield over \$3 saved in implementation.
- Sustained, disciplined management of the outsourcing relationship is critical to avoiding so-called “value leakage.”

A word to the wise: Once a company feels that restructuring may be necessary, it is imperative that the service provider is informed immediately that “business as usual” is no longer an option — especially in the case of unsatisfactory services. Withholding disputed charges is the best way to get the service provider’s attention. To this end, always pay for the services you receive, but do not pay for:

- Services that are not delivered
- Services that are totally unsatisfactory
- Services that were not properly authorized

As we have seen from the TPI survey, negotiating leverage is at risk of being reduced when restructuring a major outsourcing contract. Effective leverage in renegotiation comes only when a company has developed viable alternatives.

- Companies must be ready, willing and able to execute
- Companies also must be financially, technically, tactically and strategically feasible and desirable to potential service providers

#### **ABOUT THE SURVEY**

Respondents included 40 companies in Europe and North America, across most major industries. Contracts covered a variety of service types, including:

- IT-full (5)
- IT infrastructure (15)
- IT-ADM (1)
- Human Resources (HR) (8)
- Multi-process (4)
- Other (5)

Original contract-signing dates ranged from 1995 to 2006, with 56 percent signed between 2000 and 2003, inclusive. Original contract terms ranged from one to 10 years, with 64 percent ranging from three to seven years and 25 percent signed for 10 years.

#### **FOR MORE INFORMATION**

For more information about this survey or about TPI, please contact Stuart Harris, Partner & Data Management Center of Excellence Leader, at [stuart.harris@tpi.net](mailto:stuart.harris@tpi.net) or +1 972 380 2724.

#### **ABOUT TPI**

TPI is the sourcing advisory industry founder, and the largest advisory firm in the world focused on a broad range of business support functions and related research methodologies. Applying deep functional domain expertise of accomplished industry experts who possess extensive practical experience, TPI collaboratively works with organizations to help them optimize their business operations through the best combination of insourcing, offshoring, shared services and outsourcing. For additional information, visit [www.tpi.net](http://www.tpi.net).



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