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# Gainsharing in Procurement Outsourcing (PO)

## Can it Really Work?

Saurabh Gupta, VP, BPO Research, Everest Group

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## Introduction

The large cost base makes the PO business case attractive but it also makes the implementation process challenging. Reasons:

- Complex change management
- Difficult to baseline
- Managing savings leakage
- Organizational challenges

The potential bottom-line impact that Procurement Outsourcing (PO) can create is high, but it also makes the PO implementation process complex and challenging. The complex roadmap to realizing PO savings often generates tension in the buyer-service provider relationship. Hence, pricing strategy in PO is a critical component to ensure the right behavior from all parties.

Amongst all prevalent PO pricing models, gainsharing always evokes the strongest emotions – both for and against. Theoretically, gainsharing on percentage-spend-reduction achieved fits well with the PO value proposition that is centred around spend-unit reduction. However, in reality, pure gainsharing in PO contracts is rare (only around 4 percent of 254 contracts analyzed) though adoption of hybrid pricing structures (managed services model in combination with performance-based incentives or gainsharing) is increasing.

The objective of this research is to describe the market dynamics around gainsharing in PO and share perspectives on key considerations to make it work. It discusses:

- Role of pricing strategy in PO
- Prevalence and adoption of pricing structures in PO
- The pros and cons of gainsharing
- Making gainsharing work, supported by a case study
- Best practices and lessons learnt

## Role of Pricing Strategy in PO

The cost base for PO is fundamentally different and significantly larger than most other BPO segments. The primary component of the PO cost base typically includes non-core spend categories such as mail and supplies, advertising and promotion, IT, telecom, facilities, professional services, MRO, and HR services. Everest Group estimates that PO initiative spanning the entire Source-to-Pay (S2P) process addresses a cost base that could represent 5-15 percent of an organization's overall revenues. This is significantly larger than the operational costs addressed by most other BPO segments (typically less than 1 percent of the overall revenues). As a result, the potential bottom-line impact that PO can create is high. Everest Group's benchmarking of PO contracts reveals that on an average, organizations that outsourced procurement realized 5-10 percent savings on their outsourced procurement spend. This translates into a 5X to 10X ROI with a pay-back of around 12 months.

The large cost base makes the PO business case attractive but it also makes the implementation process challenging for the following reasons:.

**Complex change management.** A PO initiative impacts the enterprise-wide procurement spend, as opposed to just the process cost. Outsourcing procurement impacts a large number of stakeholders – both internal (finance, procurement, and individual departments) and external (vendors for procured goods and services).

**Difficult to baseline.** It is difficult for buyers and the PO service providers to baseline costs, as pre-outsourcing spend visibility is often elusive because of lack of installed procurement systems and processes.

**Managing savings leakage.** One of the biggest challenges in realizing the PO business is managing the savings leakage – ensuring that savings flow to the bottom line.

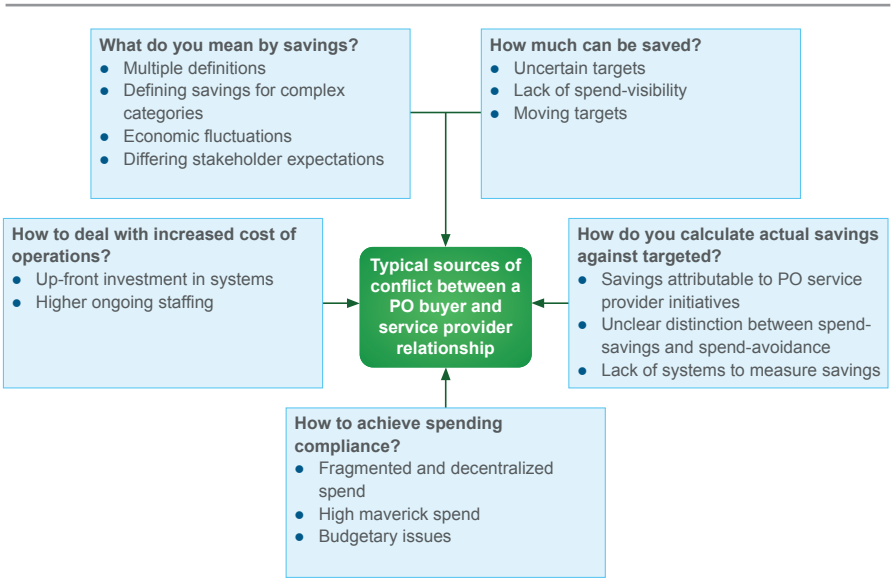
**Organizational and technological challenges.** Stakeholder management is complex, as a P2P offering straddles both the finance and procurement organizations. Technology integration can lead to logjams due to lack of an end-to-end solution.

The complex roadmap to realizing PO savings often generates tension in the buyer and service provider relationship (see **Exhibit 1**). Consequently, the pricing strategy in PO becomes a critical component to ensure the right behavior from both the buyer and the service provider.

**EXHIBIT 1**

Typical sources of conflict between PO buyer and service provider

Source: Everest Group




Risks can be allocated in an outsourcing deal, but total risk is shared by the buyer and the service provider. It is imperative in PO that the pricing strategy enables the outsourcing buyers and service providers to achieve the optimal risk-sharing boundary between them. This means creating a risk-versus-reward framework, where the buyer's risk-to-reward ratio is optimal but, at the same time, all the risk is not shifted to the service provider. In the absence of such a natural risk-reward boundary, interests can often get misaligned, creating a lose-lose scenario.

## Prevalence and Adoption of Pricing Structures in PO

Everest Group analyzed 254 PO contract. We found that a managed-service fee is the most prevalent pricing structure and pure gainsharing in PO contracts is rare.

Pricing model refers to the mechanism by which a service provider determines its charges to a buyer. This includes the type of pricing units, the degree to which elements are fixed versus variable, impact of volume fluctuations on the total charges, and the mechanisms used to adjust prices over time. We can classify the spectrum of pricing options into three broad buckets. Other variants to these three pricing models exist and often combination or hybrid approaches are also leveraged.

FTE-based pricing. Based on the service provider's units of resource input to provide services (e.g., per FTE, time, and materials). FTE-based pricing is strongly tied to cost drivers and there is a direct correlation to "how" the process is performed. However, there is limited, if any, meaningful correlation to business drivers.

Managed-service fee pricing. Fixed fee for a pre-determined volume of purchasing activity with a "dead band" cushion (e.g., fixed fee for volume of spend managed). In some contracts, Additional/Reduced Resource Charges (ARCs/RRCs) are also used to account for volume fluctuations. Given that managed-service fee is based on an aggregated level of process output, it encourages investment by service providers to increase productivity. However, it is still not tied to the desired business outcome.

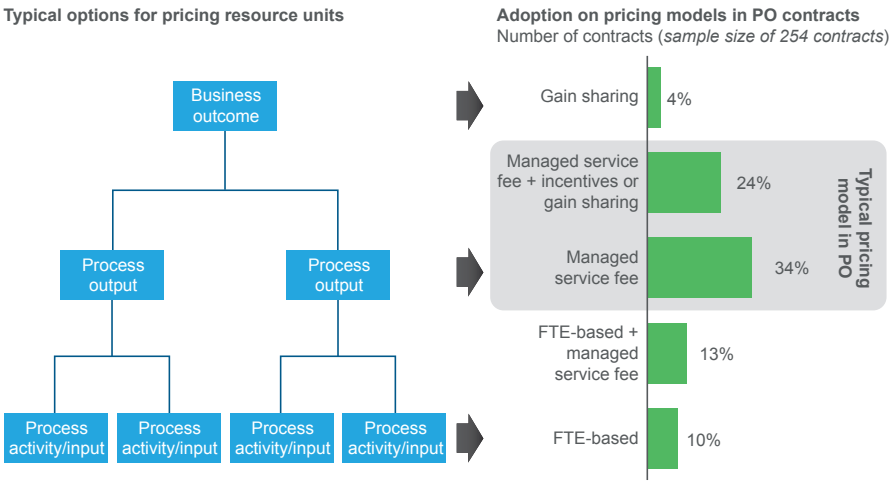
**Pure gainsharing.** Based on the outcome achieved by the service provider's contribution (e.g., percentage-spend reduction achieved). Pure gainsharing is directly related to the business and measures business outcomes, not process outputs or inputs.

It seems, at least theoretically, that gainsharing is the most evolved pricing structure and should be a popular choice for PO contracts, given that there is direct correlation with business outcomes. However, when Everest Group analyzed 254 PO contracts, we found that a managed-service fee is the most prevalent pricing structure (see Exhibit 2).

**EXHIBIT 2**

Adoption of pricing structures in PO

Source: Everest Group




In fact, pure gainsharing in PO contracts is rare though adoption of hybrid pricing structures (managed services model in combination with performance-based incentives or gainsharing) is increasing – primarily to provide a skin-in-the-game for the service provider. Let us try and understand why gainsharing has failed to make a mark in PO thus far.

…within six to twelve months of the contract, the relationship started to turn sour primarily because the gainsharing based pricing model was driving the exact opposite behavior from all stakeholders than originally envisaged.

## The Pros and Cons of Gainsharing

Everest Group estimates that up to 60 percent of the total value is created through spend-unit reduction in an end-to-end S2P PO contract. Hence gainsharing on percentage- spend reduction achieved fits well with the PO value proposition.

There are three primary tenets of a PO value proposition - spend-unit reduction, internal and external compliance, and operating improvements. While the value proposition depends on the scope of the engagement (both process scope and category scope), Everest Group estimates that up to 60 percent of the total value is created through spend-unit reduction in an end-to-end S2P PO contract. Gainsharing on percentage-spend-reduction achieved thus fits well with the PO value proposition. It should enable value creation from both the buyer's and the service provider's perspective.

Advantages of gainsharing from a buyer's perspective:

- Risk is shared with the service provider with no/negligible up-front investments required from the buyer
- Service provider is highly incentivized to create value
- Tracks business outcomes and not process inputs or outputs

Advantages of gainsharing from a service provider's perspective:

- This structure can generate better margins
- Relatively easier sell, given that buyers are not required to make any investments
- Helps to elevate the relationship with the buyer through better alignment of objectives

However, in reality, there have been many challenges in implementing gainshare as evidenced in the following disguised case study.

A large organization in Australia outsourced a large part of its non-core procurement spend to a PO service provider. To capture procurement savings, the buyer leveraged a gainsharing structure primarily to motivate the service provider. The service provider also agreed to put a significant portion of the fees at risk primarily to get a foot in the door. However, within six to twelve months of the contract, the relationship started to turn sour, primarily because the gainsharing based pricing model was driving the exact opposite behaviour from all stakeholders than originally envisaged.

- The retained buyer organization was reluctant to cooperate as there was no internal incentive for them to contribute – no additional budgets were allocated to them
- The service provider was also reluctant to make up-front investments as the entire fee was at risk and it did not get the requisite approvals from its own senior management to invest
- In one particular category, the service provider negotiated significant savings but the buyer organization wanted to avoid high gainshare pay-out
- It was difficult to track, validate, and attribute actual savings to service-provider-driven initiatives versus buyer's internal initiatives. This was also effort-intensive for the buyer's governance organization

Given such challenges in implementation, we witness pure-gainsharing pricing only in contracts where the service provider has a very high probability of achieving the savings or where the service provider is trying to make an entry into a new buyer account. Having said that, there are successful implementations of gainsharing in PO where both the buyer and the service provider realized significant value through its implementation. So what does it really take to make gainsharing work?

## Making Gainsharing Work in PO

The past failure of gainsharing based PO arrangements are the result of both parties rushing to sign and implement a deal and overlooking the importance of establishing a firm foundation of data, process, and trust. To make gainsharing work, both the parties need to ask the following key questions:

**Is the scope appropriate for gainsharing?** Gainsharing works well in cases where the desired outcome and accountability can be clearly defined and captured contractually. Typically, we have seen gainsharing being leveraged in PO contracts that are sourcing-focused (percentage of spend-unit reduction) as opposed to P2P-focused contracts (typically priced on managed service fee or FTE-basis).

**How to define "PO savings"?** Different stakeholders have different objectives, which complicates the business dynamics of defining "savings". There are essentially three variants of savings definition in PO, these are largely dependent on the underlying scope:

- Identified savings: Savings potential based on analysis of the existing spend base leveraging the service provider's benchmarks, industry best-practices, market intelligence, and category experience

- Contracted savings: Post the spend analysis; the service provider also undertakes strategic sourcing initiatives to negotiate better contracts. This model measures savings as price differential between new or renegotiated contracts and the old sourcing contracts over the volume of the category purchased

- Realized savings: In this model, savings are not considered valid until spending has occurred. Realized savings are measured as the difference between the original, i.e., pre-sourcing cost, and the actual price paid based on an analysis of invoices and/or payables

Not having an agreed-upon savings definition between the buyer and the service provider can lead to unrealistic expectations and can become a major point of discord between the two parties.

**How will savings be calculated?** Savings can be calculated as incremental price reductions over existing price points for the category. This is the most commonly used definition of "savings" and is typically used for commodity-like, product-based categories such as office supplies, facilities, and MRO. However, savings calculations can become fairly complex especially for services such as marketing, advertising, and discretionary spends such as software. For example, in marketing-related categories, savings cannot be calculated at the cost of each marketing event,but by breaking it down to the components of a marketing event – hourly rates of people involved, printing costs, etc. For a category such

as energy, absolute benchmark will be a challenge after, say, three years because the prices are highly dependent on inescapable market conditions. Hence, a relative indexation methodology is used for categories where the key point is not to provide absolute savings but to buy at prices lower than the buyer's peers.

**What is the baseline methodology?** Most organizations do not have robust baseline data and service providers often rush through the base lining exercise. This is the most common pitfall of a gainsharing implementation. Service providers need to spend significant time and effort up-front on baselines to identify unit price paid. This due diligence phase includes discussion with vendors and helps to establish a probability of success. This process can start before the contractual commitment but runs into the live contract. Such detailed due diligence provides a much more accurate and realistic picture of the savings potential. Pre-contracting agreement between the buyer and the service provider on the item-level, purchase cost baseline and indexing, as appropriate, is critical to avoid some of the pitfalls of gainsharing highlighted earlier.

**How to ensure savings are realized?** Once the buyer and the service provider have agreed on a savings target, the key challenge is measurement of actual savings against targeted savings. A number of factors contribute to the procurement spend-related savings, e.g., contract renegotiations, use of technology, reduced maverick spend, and better demand management. These factors could be attributed to either the service provider or buyer initiatives. Moreover, it is also difficult for the buyer and service provider to draw the line between hard-dollar savings (getting an airline ticket for US$400 instead of US$500), as opposed to cost avoidance (not travelling by air at all). Service providers need to be incentivized for pursuing opportunities of cost-avoidance; but they should develop the incentives as service-levels rather than linking them to gainsharing. Baseline volume against which savings will be measured also needs to be agreed up-front as buyers will tend to keep reducing the volume baseline by claiming effect of non-service provider influenced factors. The buyer's procurement organization should also have some stake in achieving the savings. Else, there would be a tendency to discredit sourcing savings by bringing up quality issues or claiming the alternative is not apples-to-apples. Also, extracting savings from the budget and delivering tangible benefit to the CFO organization is critical. Leaving the "savings" in the business to be spent by the budget holders is not savings at all, just more to be spent.

## Best Practices and Key Lessons Learnt

Beyond the considerations described above, it is important that both the buyer and service provider have a risk appetite, are willing to invest, and have built high levels of trust in the relationship. There exist instances where gainsharing was successfully implemented in a PO environment. Illustrated below is one such case study of a successful gainsharing implementation.

**PO gainsharing implementation case study: BAE Systems, Inc. – Xchanging**

**Buyer details:**
- *Revenue*: ~$20 billion
- *Industry*: Defense and aerospace
- *Countries of operation*: Worldwide

**Drivers and objectives:**
- Free up investment to focus on managing the supply chain more effectively to gain a competitive edge in the market
- Pursue breakthrough incremental savings to contribute to the on-going cost saving efforts
- Seek better control, visibility, and compliance of indirect spend
- Ensure that savings are sustained through continuous improvement and by avoiding leakages

**Pricing construct:**
- Gainsharing on realized savings and category-specific SLAs
- Realized savings measured on actual price paid against a fixed and indexed baseline, at a subcategory level
- Transparent baselining methodology with transactions that are open book and auditable

**Winning theme for Xchanging:**
- Existing relationship in another region allowed Xchanging to understand and provide a solution consistent with BAE Systems' requirements
- Provided access to top procurement talent supported by a proven approach to sourcing
- Gainshare approach was innovative and a differentiator
- Clear philosophy of being focused on outcome not inputs

**Contract details:**
- *Duration:* 7 years
- *Managed spend:* US$800 million
- *Process scope:* Spend analysis, strategic sourcing, and vendor management
- *Category scope:* IT and telecom, transportation, contract labor, industrial supplies and services, utilities, and some professional services
- *Geographic scope:* United States
- *Delivery locations:* Chicago (United States)

**Key learnings:**
- Involve key stakeholders early and often
- Secure an executive sponsor outside of the procurement function
- Procurement head must play an active role is securing internal support
- Follow a strong spend-baselining approach
- Build mutual trust by taking a phased approach

**Expected results:**
- Expand use of existing technology/ infrastructure and bring in new technologies to fill gaps
- Align the sourcing process to fully understand business requirements, create deeper category expertise, and prioritize initiatives
- Local support in business requirements definition and implementation
- Sourcing initiatives to support the targets and goals set by the organization
- Improved tracking of savings by improved calculations, and reporting
- Better supplier management by allocating more resources to manage performance
- Increase the percentage of indirect spend under formal commodity management

**"Xchanging was willing to make the necessary upfront investments, which showed us that they were willing to take the risks and hence gave us confidence in their abilities."**

*– Dennis Bent, Corporate Vice President Procurement, BAE Systems, Inc.*

There is no "nirvana" to pricing strategy in PO, and every structure has its own pros and cons. However, a well-designed pricing structure should help align both the buyer's and the service provider's interests. Everest Group has come up with 10 best practices to help create this alignment in PO relationships:

1. The commercial structure should be designed around your company's needs – not around what the latest trend is. Pricing model should be simple and easy to manage

2. Get into the principles early – leaving the discussion on savings until the solution design and negotiation stage will be too late

3. Involve all stakeholders (procurement, finance, and individual departments) in the buyer organization – the definition of "savings" should be agreeable to all stakeholders before signing the contract

4. Do not short-change spend baselining. It is the key success factor to understand the realistic ROI of a PO engagement

5. PO service provider's track record is an important selection parameter – a PO program requires trust

6. Understanding organizational risk appetite is essential - there is always some degree of uncertainty in predicting a savings target, and a higher level of guarantee comes at a cost

7. Work in the spirit of partnership – be prepared to share the pains along with the gains

8. Strong contractual framework that is flexible to changes in the environment is very useful – very unlikely that nothing will change over a five to seven year period

9. Incentives to drive the right behavior – both internal as well as external – are key

10. Governance and monitoring should ensure that PO savings are realized to the bottom line and are not leaked away

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## About Everest Group

Everest Group is an advisor to business leaders on next generation global services with a worldwide reputation for helping Global 1000 firms dramatically improve their performance by optimizing their back- and middle-office business services. With a fact-based approach driving outcomes, Everest Group counsels organizations with complex challenges related to the use and delivery of global services in their pursuits to balance short-term needs with long-term goals. Through its practical consulting, original research and industry resource services, Everest Group helps clients maximize value from delivery strategies, talent and sourcing models, technologies and management approaches. Established in 1991, Everest Group serves users of global services, providers of services, country organizations, and private equity firms, in six continents across all industry categories. For more information, please visit www.everestgrp.com and research.everestgrp.com.

## About Xchanging

Xchanging is a business process and technology service provider and integrator specializing in Financial Services, Insurance Services, Technology and Procurement, with pervasive processing skills and capabilities applicable to other vertical industry and market sectors.

**For more information about Everest Group, please contact:**
+1-214-451-3110
info@everestgrp.com

**For more information about this topic please contact the author(s):**

Saurabh Gupta, VP, BPO research, Everest Group
saurabh.gupta@everestgrp.com