

The ROI of Outsourcing



Cost-effectively managing your applications and infrastructure (in a world where every dollar counts)

WHITE PAPER



NaviSite

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The Current Environment

The current economic environment has caused companies of all sizes to re-evaluate how they do business, with an eye toward finding – and exploiting - areas for cost-savings and productivity gains. Often, there is a call to return to the “basics” and core competencies of the business. In addition, companies must do more with less. One potential way of accomplishing these objectives is through outsourcing the functions that enable, but aren't directly related to, their strategy. Many companies outsource functions like payroll and accounting, recruitment, facilities management. Many also outsource part, or all, of their information technology (IT) function.

According to the Global Outsourcing Report published in March 2005, “Three-quarters of U.S. companies outsourced some or all of their information technology activities in 2004, and that percentage is likely to increase this year...” These kinds of statistics often raise concerns about the impact of outsourcing on the U.S. job market. In fact, the “2004 Enterprise Systems Outsourcing Survey” noted that “Even though the term ‘outsourcing’ has become synonymous with the practice of sending jobs overseas, the bulk of outsourcing activities – 70.2% - occur on the domestic front.”

There are a number of questions that both business executives and internal IT groups have when considering outsourcing: Is it right for our organization? Won't we lose control by outsourcing? Will outsourcing affect the performance of systems and applications? Is there really a stronger return on our investment through outsourcing?

A recent study by Geller & Company and Michael F. Corbett & Associates, Ltd. found that 93% of CFOs in mid-sized companies “...are under pressure to become more strategic [and] that one way for CFOs to become more strategic is through outsourcing finance and accounting.” The study examined CFO involvement in key strategic activities and found that 43% participate in the management of business investments in technology (including outsourcing), and another 33% take the lead in these activities. 60% said that the importance of outsourcing in the finance and accounting function had increased over the past two years.

This White Paper discusses recent changes in IT outsourcing, and examines how service offerings have evolved in response to changing business drivers and technology advances. It describes areas to consider in determining the ROI of outsourcing for your company. It also describes how NaviSite's managed service offerings and delivery models, designed specifically for mid-sized companies, can yield significant return on investment, while helping companies leverage their IT-based initiatives for competitive advantage.



Outsourcing of Old

Large enterprises have long sought to reduce expenses and focus on their core through IT outsourcing arrangements, often outsourcing “everything” and going as far as having the outsourcer re-badge some of the enterprise’s IT employees. Outsourcing arrangements in “the good old days” were often custom contracts with large monolithic outsourcing organizations. In return for cost savings, the enterprise typically ceded flexibility and control. The outsourcer provided operational efficiencies through strict procedural controls, drowning their client organizations with change request paperwork. This made managing the agreement a function unto itself, and made changes time-consuming and difficult to implement. In the “big IT” outsourcing world, this model continues to prevail.

For a variety of reasons, these types of outsourcing agreements were neither available, nor attractive, to mid-sized enterprises, leaving these companies with few choices in terms of outsourcing providers, except for project implementation work. This all changed with the rise of managed service providers which have focused on delivering services in specific functional areas, allowing organizations to “selectively outsource” functions that are not core to their business. With selective outsourcing, a wide range of options is available. Companies can choose to outsource some or all of their applications, perhaps outsourcing only those that require 24/7 support. Companies can opt for “simple” management of their networks and servers, their security systems, and/or their hardware devices. They can move up to database monitoring and management, as well as monitoring and management of the application itself. Even within the application layer, companies can choose to have outsourcers provide first level maintenance, while maintaining full control over the customized layer. Remote management capabilities enable managed services providers to offer services not only in their own data centers, but in a customer’s own premises.

Selective outsourcing provides mid-sized enterprises with choices about how much or how little control they want third parties to exercise over their application environments and IT infrastructure, while new information portal technology enables all parties involved to work collaboratively, keeping everyone in the know on what’s going on with all aspects of their system. Collaboration can extend to Systems Integrators and software providers as well. This new model allows the mid-tier enterprise to reap the cost benefits of leveraging the expertise and scale of service providers, while maintaining overall responsibility, oversight, and control of their own IT world. It provides access to the diverse skill sets needed to manage today’s complex distributed application environments and enables internal IT organizations to focus on delivering technology solutions that directly address core strategic functions.

NaviSite is a leading provider of managed services for applications, infrastructure, and messaging. By specializing in specific technologies and functions, NaviSite has been able to achieve economies of scale that previously were the exclusive realm of global IT services companies. NaviSite leverages a management framework to deliver tailored solutions, using standard platforms, tools, and processes to manage all layers of the technology stack, from the network through the application, often partnering with the SIs and ISVs who service the mid-sized enterprise to provide a complete suite of application services. NaviSite is able to maximize skill sets across multiple client environments, thereby enabling mid-sized enterprises to have access to a diverse set of skill sets without the cost burden of hiring all of them.

In essence, NaviSite becomes an extension of the IT department, not a replacement. Its combination of focused service delivery, standard tools and processes, and the maximization of remote resources results in a more cost-effective operations environment than with in-house, or with the full-service outsourcing provided by the major IT service providers. NaviSite has made an extensive investment in people, processes, and tools for event management and problem resolution. This “operational efficiency” investment – well beyond the investment level most mid-sized IT departments could afford to make – drives costs out and quality in to NaviSite’s services.



What are the Benefits of Outsourcing?

With the growing trend toward partially outsourced solutions, organizations have greater flexibility in meeting their needs. Outsourcing permits the company to focus on its core competencies and lets IT focus on core competencies that are unique or of special interest to the business. Specific advantages include:

Cost/Risk Reduction

NaviSite can reduce the costs and risks associated with IT project in several ways. First, we leverage buying for multiple customers to establish scale that cannot be matched by mid-sized organizations. This buying clout often gives us more influence with network providers and technology providers than individual mid-sized companies would have. This yields higher levels of responsiveness and quality. Second, this also allows us to share the costs of major infrastructure components such as data centers, back-up generators, shared infrastructure, network connectivity, personnel, etc. across a number of customers to gain even greater efficiencies.

Third, by dealing with multiple instances of the same software and hardware, NaviSite operations staff develops specific experience and efficiencies. This experience is increasing becoming more important as the complexity of e-Business applications grows and the demands for rapid development remain high. The cost of failure has never been higher, especially in light of ever tightening budgets.

Cost Avoidance

Cost benefits grow especially apparent as companies move business-critical applications to the web, as web enabling an application brings with it the understanding that it will be available 24/7. Mid-sized companies that provided support 9/5 are now looking at maintaining a round-the-clock IT staff. That means doubling and even tripling up on many highly specialized functions including database administrators, middle-ware experts, networking gurus, security experts, not to mention technical and customer support representatives to assist users. Avoiding the costs of staffing for this level of support are significant.

Other costs that can be avoided by outsourcing are the full costs of infrastructure – data center, networking, security and high availability devices, software, etc. – and of licensing or developing a range of tools for monitoring, event management, reporting, and testing. With outsourcing, the greater proportion of costs is avoided because, as with personnel costs, the resources are shared among many customers.

Focus on Core Business and Core Competencies

Companies may not have general IT expertise available and may not wish to develop and manage these skills since they are not related to the company's general business focus. For companies that have strong IT departments, focusing on critical software or unique skills makes it preferable to outsource general IT processes. In both cases, IT can focus on developing new systems and processes that support their company's strategy, rather than on the operational "care and feeding" of existing applications.

Improved Time to Market

Building on support infrastructure takes time, and this option may not be available for companies introducing new products and services. Outsourcing provides the ability to make rapid moves, speeding time to market and enhancing your company's ability to react to competitive threats, and to innovate.

Implementing new management systems and processes yourself can take several months or more, taking time and resources away from core IT activities and delaying the realization of the cost and performance benefits of more effective operations. Moreover, many in-house IT teams lack the experience and expertise required to effectively implement and integrate today's IT management systems — as evidenced by the amount of enterprise software owned but never implemented by enterprise buyers. Managing



systems in-house also requires dedicated staff to monitor and track network, server, and application problems, creating an operational burden that many enterprises find too costly to maintain.

Compensate for Shortage of IT Staff

Despite the current job market, global IT shortages continue. This is likely to continue, especially in specialized areas, which can be more efficiently provided through outsourcing. In addition, companies that maintain skills in-house often find that they pay a significant “training tax” when they have staff turnover. This includes not only the absolute costs of recruiting or retraining staff, but also the delays that these cause on strategic projects.

The flip side of this issue is the opportunity costs associated with trying to do everything in-house. If your IT people weren’t managing your web site, what other things might they be doing? More than likely they would be working on areas that would derive more value and differentiation for the company.

A recent study by CTG entitled “Application Outsourcing: A Competitive Advantage Tool” determined “that basic maintenance and support of the existing application portfolio consumes up to 50% to 80% of a typical IT department’s resources – posing a serious roadblock to the new initiatives and improved services that can enhance an organization’s competitive position.”

Reduced Capital Expenditures / Improved Access to Equipment

Investment in IT equipment, software, and infrastructure can be staggering. Startups and mid-sized companies may find that they have to delay strategic projects, due to restricted availability of capital to support them. NaviSite can offer a viable alternative in that our infrastructure is provided on a lease basis, freeing capital for other purposes while accelerating the ability to deploy new initiatives.

Higher Availability

Another important consideration of any IT project is the cost of downtime. While downtime does not always perfectly equate to loss of revenue, it can hurt a company in a number of ways. First, if the web site is a revenue-generating site you will lose revenue during an outage, especially if they are alternative sources for the products you offer. Second, any outage will have an impact on the users of the system (vendors, customers, partners, and employees) because it impacts their productivity. If they repeatedly encounter outages, these users will find web sites that are better performing and more highly available, having a more permanent revenue impact.

In a paper delivered at the Gartner Outsourcing Summit in April 2005, Gartner predicted that “By 2007, 80 percent of companies that rely on custom-developed solutions will fail to meet the real-time needs of their constituents, negatively impacting their competitive position in their markets.”

NaviSite has built the infrastructure to support mission-critical, revenue-producing applications. This frees your IT staff to focus on optimizing the use of the infrastructure and functionality of the site, which yields increased satisfaction across all your user constituencies – customers, partners, suppliers, employees.

Buffer from Changing Environment

NaviSite also protects companies from technological obsolescence, further reducing capital investment demands while staying current with technology. We develop expertise with new technologies and, more importantly, with migrating from one environment to another, reducing the potential issues that arise from these transitions. We even have staff who specialize in migration and maintenance functions that could not be justified in an IT department because the skills are used infrequently.

In addition, by using the NaviSite environment, companies often gain significant flexibility to modify their environment to take advantage of shifts in technology.



Is Outsourcing Right for Your Company?

Whether your pain is cost considerations, difficulty in finding and retaining skilled staff, the need to rapidly deploy strategic initiatives, or the need for higher levels of quality, the realities of the business climate put outsourcing on the map as an option to evaluate. But is it right for your company?

Gartner has conducted exhaustive studies on outsourcing adoption rates by industry. The high-level survey results presented at the Gartner Outsourcing Summit in April 2005 concluded:

- Adoption rates vary by vertical market
- Outsourcing drivers and inhibitors vary by vertical market

The highest adoption rate for IT and business process outsourcing was found among financial services companies (\$57 million) with manufacturing running a close second (\$45 million), and government a near third (\$37 million). Approximately 61% of this global spending is for IT outsourcing (ITO) and the remaining 39% is for the newer concept of business process outsourcing (BPO).

The outsourcing drivers varied by industry, which can be seen by looking at the top reason executives in different vertical markets cited for their current and future planned use of outsourcing:

- Healthcare – Reduce costs
- Manufacturing – Enable internal IT staff to focus on strategic projects
- Retail – Operational efficiency
- Transportation – Standardize technology across company
- Utilities – Enable internal IT staff to focus on strategic projects
- Communications – Enable internal IT staff to focus on strategic projects
- Energy – Reduce costs
- Financial Services – Standardize technology across company
- Government – Enable internal IT staff to focus on strategic projects

Gartner's overall recommendation is to outsource the most inefficient processes and IT solutions, be they generic or industry-specific.

The choice of whether to outsource or not can only be made at the individual company level. It depends on a lot of factors, but a couple of key areas for consideration include:

Delays in Strategic Projects

If access to capital and expense resources has hampered efforts to launch new service initiatives or improve the functions of existing systems, outsourcing may offer a way of accelerating these projects. Outsourcing can also help in cases where it is difficult to adequately maintain the staff needed to deliver projects under tight timeframes. Here, IT staff is allowed to focus on the areas of greatest differentiation and value, rather than with managing the infrastructure.

Issues with System Performance or Scalability

Perhaps you have experienced an outage or performance issues that impacted customers or partners. Or you may be approaching a level of traffic that requires additional capital investments just to keep up with demand. Outsourcing can help address these concerns offering increased levels of availability, performance, security, and scalability, typically at costs significantly lower than a mid-sized company can achieve on their own.



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Looking to Get Greater Return on Your IT Investment

Web sites are becoming more critical to companies of all sizes. But just keeping up with all the technological advances can quickly devour IT budgets with little visible return. Outsourcing infrastructure and application management components can greatly improve the return a company gets on its investment through cost-savings of the leveraged infrastructure of a managed service provider as well as having their team focused on innovations in the applications that help differentiate the company.

In the next section, return on investment is examined in more detail.



Do the Math – Performing the Financial Analysis

The fundamental outsourcing value proposition is based on reduced total cost of ownership, or TCO. This is not to say that cost is the only factor driving outsourcing decisions. Enterprises also look to outsourcing to create predictable cost structures and refocus internal resources on core competencies. However, in the current economic environment, cost issues have a way of influencing other factors that drive outsourcing decisions. For example, the growth of distributed computing through client-server and Internet technologies has made application environments increasingly complex and difficult to manage cost-effectively in-house.

When determining the worthiness of an outsourcing decision, it is important to put a comprehensive set of financial figures – covering both obvious costs (such as physical equipment and infrastructure, and direct personnel) and hidden costs (management overhead, space allocation) - into a model for financial analysis, ensuring that the sourcing option with the highest value to the firm will be selected.

Comparing current budgets to proposed budgets, helps determine if the outsourcing decision is financially sound. The items used in the comparison are operating budget, overhead budget, and capital budget. By comparing these budgets we can determine the budgetary cost savings associated with outsourcing.

Additional costs, both tangible and intangible must also be calculated to determine any savings. Items to consider when creating a current cost budget include off-budget costs such as occupancy, training, and benefits. Support services such as management, human resources, and finance and administration should also be measured as well as capital costs, such as useful life, depreciation, and market value. Lastly, paying attention to assumptions, such as future volumes, service level requirements, technologies, and costs will play a large role in calculating and comparing the budgetary implications of current and proposed sourcing. Also, when considering proposed budget implications for the outsourcing initiative, it is helpful to bear in mind the providers' start-up cost, changes in volume and scope of services, changes in indexes or cost drivers, pass-through expenses, and retained costs.

Other budgetary costs, including planning costs, transition costs, oversight costs, actual and opportunity cost analysis, and additional costs and risks should be taken into account. Considering additional costs such as one-time costs, ongoing costs, and tangible and intangible costs is crucial. The calculation of current and proposed additional benefits may greatly impact the worthiness of an outsourcing proposal. These additional benefit considerations include one-time benefits, ongoing benefits, tangible and intangible benefits, quality capacity, capital, opportunity benefits, and additional benefits and rewards such as organizational change, employee morale, breakthroughs, unexpected synergies, and new revenue opportunities.

ROI analysis is also a powerful tool when calculating whether an outsourcing initiative is beneficial to an organization. Cash flow, cumulative cash flow, payback, net present value, and internal rate of return are all factors that shape an organization's return on investment.

According to the Geller & Company study cited above, "...few organizations truly understand the total costs of their current financial and accounting operations. This often makes outsourcing appear more expensive than it actually is." Companies that conduct a thorough cost analysis generally find that outsourcing is profitable. A major Los Angeles hospital center reported that outsourcing the management of their business and clinical information systems resulted in a monthly drop in IS operation costs of 10 to 12 percent (\$2 million annually) and an overall improvement in service quality.



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By conducting a thorough financial analysis of both current and proposed budgets, an organization can be ensured that all costs are measured and the sourcing option with the greatest overall value to the firm will be selected for sourcing.



How Should an Organization Select an Outsource Partner?

Selecting an outsourcer requires careful consideration. Important things to look for include:

- ⇒ Demonstrated expertise in the areas of interest, including past work for similar firms.
- ⇒ Reasonable cost structure and a clear definition of services offered.
- ⇒ Compatible infrastructure, including hardware, software, management tools, and network facilities.
- ⇒ Good references from clients with similar needs.
- ⇒ Organizational strength, including size, time in the business, and reputation.
- ⇒ Adequate staffing and management structure to handle normal operations and well as emergencies.
- ⇒ Service Level Agreements.
- ⇒ Work Style/Process– Extension of IT Staff.
- ⇒ Experience with and commitment to the mid-sized enterprise.
- ⇒ The ability to provide full suite of services (including application development and on-going application maintenance), either on their own or through partnerships with Systems Integrators.
- ⇒ Technology that provides full visibility to the customer's IT group, and supports multiple groups working in collaboration.

Traditional full-service outsourcing delivery models developed for large enterprises with IT investments do not translate well to the needs of mid-sized companies. Outsourcers and service providers need to operate as a partner with the customer, rather than just a vendor. This means finding ways of managing changes without requiring voluminous processes or paperwork and finding ways of fostering uncompromising cooperation.



Outsourcing – Your Solution for Regulatory Compliance

An ISV that has made the decision to include or go exclusively with an outsourcing provider needs to ensure that the vendor is capable of delivering the requisite physical, technical, operational, intellectual, and human resource requirements for delivering best-in-class service. These can generally fall into two categories: Hosting Delivery Services and Business Delivery Services. Hosting Delivery Services pertain directly to the actual operation of running the ISV's software in a hosted environment. Business Delivery Services are those relating to how the service provider works with the ISV in establishing and supporting its SaaS business.

Compliance today means adherence to at least a score of governmental regulations at various levels, including but not limited to Sarbanes-Oxley, Gramm-Leach-Bliley Act, HIPAA, California Security Breach Information Act, European Union Data Protection Act / Safe Harbor, and SEC Rule 17a-4. Most of these regulations, from an information technology perspective, pertain to the security of data, data that needs to be protected at the application and/or infrastructure layer.

For many companies, compliance is not only a costly and time-consuming effort, it is also a distraction, a function that diverts resources from the company's main business objectives. By outsourcing compliance, companies can therefore save time, save money, and focus on their core businesses.

Still, it's not always an easy decision. If you're responsible for compliance and the security of your company's and your customers' most private data, does it make sense to entrust someone else with that job? In many if not most cases, the answer is yes. And the reason is simple. Security is not your area of expertise. There are, however, firms that do specialize in just that, and have made a significant investment in the tools required to provide for data security and regulatory compliance.

NaviSite is one of those companies. Our carrier-class data centers are SAS 70 Type II certified. SAS 70 is a Statement of Auditing Standards (SAS) for service organizations and an internationally recognized auditing standard developed by the American Institute of Certified Public Accountants (AICPA). A SAS 70 audit or examination is widely recognized, because it represents that a service organization has been through an in-depth audit of their control activities. The SAS 70 process is similar to the ISO17799 code of practice, and the BS77992 specification for information security management.

Customers who host their data in one of NaviSite's SAS 70 compliant data center can meet most of their regulatory requirements through NaviSite's Type II audit report.



Conclusion

Mission-critical applications are increasingly available on the web, which increases demands for 24/7 support, high availability, quick performance, and complete security. At the same time, complex and often contradictory pressures to deliver faster yet with fewer people and lower costs are forcing companies to consider new ways of doing business. Traditional full-service outsourcing delivery models developed for large enterprises with IT investments measuring in the tens of millions typically do not translate well to mid-sized companies. Fortunately, there are alternatives, including service providers like NaviSite, which have developed infrastructure and services specifically for the mid-tier market. We operate as a partner with the customer, rather than just a vendor. This creates not only operational efficiencies, but also significant cost-savings in a number of areas.

Outsourcing can build long-term, sustainable competitive advantage. It does this by changing the rules and extending the organization's reach. Companies can focus on areas that are core to their business and that derive true business value and differentiation. Outsourcing, new technology, and new processes are an amazingly powerful combination and can be enjoyed by companies of all sizes. It enables companies to cost-effectively operate in Internet time and space, without sacrificing the availability, security, and reliability that mission-critical applications demand.



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About NaviSite

NaviSite provides IT hosting, outsourcing and professional services for mid- to large-sized organizations. Leveraging a proven set of technologies and extensive subject matter expertise, we deliver cost-effective, flexible solutions that provide responsive and predictable levels of service for our clients' businesses. Over 900 companies across a variety of industries rely on NaviSite to build, implement and manage their mission-critical systems and applications. NaviSite is a trusted advisor committed to ensuring the long-term success of our customers' business applications and technology strategies. NaviSite has 14 state-of-the-art data centers and eight major office locations across the U.S., U.K. and India. For more information, please visit www.navisite.com.