

Pricing Outsourcing

By Simon Pilkington

Understanding the Different Pricing Needs of Clients and Providers

A lot of ink has been spilled in recent years on the subject of investment management outsourcing. The concept has gained widespread acceptance as investment managers realise that they can focus better upon their core competencies – managing money, developing new products, distribution methods, client service, and so on – by shifting their investment operations, fund accounting and other administrative functions to specialist third-party providers. Managers who outsource these functions do so with the expectation of controlling risk levels, improving service quality, gaining access to proven and superior technologies and, ultimately, saving money or at least gaining better control of what can often be a variable cost.

An intelligent, strategic outsourcing solution should yield all of these benefits, but as is often the case in many aspects of investment management, the bottom line remains the top concern for many managers thinking about outsourcing. Even clients who say that saving money is not their main concern end up focusing upon direct costs or other indirectly cost-related business drivers such as service quality, increased instrument coverage or improved technology. And this focus inevitably raises a tricky issue: how does one put a fair price on outsourcing services? In what is still a maturing field of the investment business, where costs have not yet coalesced around generally accepted industry standards, there are no easy answers to this question. But analysis of this question from the standpoint of both outsourcing clients and providers – considering such factors as length of the deal, up-front contract premiums, benchmarking and rate card structure – is critical in establishing what both sides really want and where the middle ground might lie in any given outsourcing contract.

Immediate cost savings are usually high on the agenda of potential outsourcing clients, and in some cases clients also look for an up-front premium based on the value they place on their business. In order to close an outsourcing deal, both sides will need to spend a lot of time, and therefore money, in due diligence and implementation planning processes. So if immediate cost savings are to be achieved, this would require the provider to underwrite the costs incurred in the initial years of the agreement.

At this stage in the development of the outsourcing industry, it is questionable whether large, well established providers need to pay up-front premiums, as all of the large providers now have existing clients and infrastructures. It is possible that some smaller players looking to enter the market may be prepared to pay a premium, but prospective clients need to balance this immediate financial benefit against the risk of using a provider which hasn't yet established its skills and abilities in the market. The advantage for providers and potential clients in this situation concerns the client's intellectual capital, as experienced staff will bring significant benefits to the provider in return for cost savings for the client. This is especially true in a lift-out arrangement, in which the provider takes over the client's existing operations (effecting a complete transfer of both technology and staff). But again, established providers might not necessarily find such arrangements appealing in the future.

Obviously, the willingness to compromise on both sides is crucial in establishing a mutually beneficial outsourcing arrangement. One of the advantages of outsourcing from a client's perspective is that it helps them move from a largely fixed set of costs to a more variable cost structure, but while they want to benefit from economies of scale as their business grows, providers need protection against their business declining. One could argue that the ideal tariff for a manager is to pay for services measured by basis points on assets under management. This is how managers are typically compensated, giving them the certainty of costs being a fixed percentage of revenue as assets under

management grow or shrink. But most outsourcing clients have indicated a preference to pay a tariff based on volume, and tend to be less interested in ad valorem charges. Providers also want a tariff which reflects the economics of providing the business, structured to reflect the drivers of volume and complexity. So while clients typically gain the variable cost advantage they're after, they also need to accept that there is still a fixed cost aspect from the provider's perspective.

One of the questions providers usually ask early in the process of negotiating an outsourcing deal is how much the client's operations currently cost. This question usually puts clients on the defensive, probably out of suspicion that the provider is going to take their cost and pitch a fee just below it, whereas without the existing costs as a benchmark the provider might offer a better deal. But in reality, this information is critical to the potential provider, especially if a lift-out is being contemplated, for until the business converts to the provider's technology, the existing costs will be incurred by the provider. By being cagey on this subject, a client may put its potential provider in an impossible situation, leaving it unable to adequately assess one of its key drivers in any deal. Successful outsourcing relationships are partnerships based on trust, and this trust needs to be established early in the negotiation process so that both parties can deal with each other in an open, honest way.

Length of a proposed deal is an important factor, and often a complicating one. The longer the arrangement, the more compelling a provider can make its proposition; too, benefits can be gained over the long haul by using more than one service. Clients, however, will need a potential exit strategy covering operational, IT and cost considerations in case things go wrong:

- Operational aspects may be complicated in the case of a lift-out, with the possibility that the operation may still be running as a separate and distinct unit at some point in the future.

- IT revolves around connectivity and the client's ability to retain ownership of their data.
- Cost considerations will depend on the contract period still to run, and the extent to which the provider has been able to absorb any up-front costs incurred.

And in longer arrangements, clients are likely to look for the opportunity to benchmark their services and prices. With benchmarking exercises, clients hope to protect against the possibility that the overall market value for services may fall, which would put them at a disadvantage relative to firms which outsource at a later date. In fairness to providers, the benchmarking exercise should also include upside potential for them, providing compensation to them if the cost of service provision becomes more expensive than originally envisaged.

Especially across longer deals, how does one anticipate future events such as acquisitions by the client – or of the client by a third party? The contract will probably contain clauses which allow both parties to reassess the relationship in the case of significant change, but most clients have an acquisitive strategy, and are likely to want cost certainty in case they grow by acquisition. This is not always easy to model: it is one thing to create a rate card which is tiered for the gradual growth of existing business, quite another to accommodate the sort of explosive growth which may result from an acquisition. And pricing the transaction is only one element of crystal ball-gazing. Will the operations be located in the same city? Will the acquired entity have similar or different systems? The price of an outsourcing deal already varies if multiple sites have to be used instead of a single site, or if the existing provider's site is not sufficient and a new site has to be arranged. Connectivity is an important issue when pricing a deal: a single pipe into the client's data warehouse or data store is more straightforward and less expensive than a multiple point-to-point system. Factoring in the possibility of acquisitions, and their effect on considerations like these, makes pricing a deal that much more difficult.

Naturally, the type of deal being pursued will greatly affect the type of savings a client can hope to gain. Most deals are either lift-outs or straight conversions, although some are a mix of the two. Within our current context, lift-outs can be thought of as a means to an end: they will involve the transfer of qualified and experienced staff who know the client to the provider, but they will inevitably cost more up front, as the business will initially be run on legacy technology which is not leverageable. Conversions require the provider to have experienced staff immediately capable of redeploying to meet the new client's needs, and are likely to provide a more immediate financial advantage. However, this apparent advantage must be weighed against the costs of redeploying or laying off staff after the conversion is completed, whereas most lift-outs will eventually involve a conversion to leverageable strategic technology. Qualified and experienced staff joining the provider in a lift-out are likely to be closely involved in defining business requirements and conversion activity, and as such constitute an asset in their own right.

In the final analysis, no two outsourcing deals will be hugely similar – the intricacies of establishing a close relationship between client and provider mean that the pricing of such deals can only be determined on a case-by-case basis. Ultimately, clients usually want a simple rate card, something which fixes their variable costs at advantageous rates which can be structured to match the economics of the deal. A tiered structure may provide protection against growth, but if the client expects to benefit from unit cost savings over the life of the deal, the rates need to be discounted accordingly. And of course, past growth of a client is no guarantee of future growth – it is difficult to assume anything in this regard, so financial analysis needs to include sensitivity analysis to determine the impact of various growth rates for different drivers on the economics of a deal. Establishing a worthwhile outsourcing arrangement requires a great deal of trust and coordination between both client and provider; it is fair to say this same level

of trust, and the establishment of a comprehensive understanding of each other's needs, is equally necessary before any deal is signed.

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