A SPECIAL SUPPLEMENT TO:
Logistics MANAGEMENT

Special Report: State of Third Party Logistics

TOP 50 3PLs

Will mergers and acquisitions alter the landscape?

A flurry of major service provider deals captured mainstream headlines in recent months, but the consequence of this activity has yet to be measured by domestic and international shippers. Meanwhile, the EU flounders, Asia remains strong, and emerging nations may represent the next great opportunity for the major 3PL players.

By Patrick Burnson, Executive Editor

European sovereign debt issues, a tepid U.S. recovery, and a hard landing in emerging markets—among a slew of factors—could provide macroeconomic shocks to the third party logistics (3PL) industry, say leading market analysts. Still, many catalysts are expected to drive merger and acquisition activity over the rest of 2012.

According to PricewaterhouseCoopers (PwC), the transportation and logistics industry continues to be highly cyclical. "A continuing theme in the first half of this year has been infrastructure deals, particularly in emerging markets, that reached a historic high in the logistics sector," says Ken Evans, U.S.

CONTENTS

Top 50 global 3PLs	46S
Top 30 domestic 3PLs	48S
CEVA executives discuss global 3PL market	54S

transportation and logistics leader at PwC.

In fact, in the first quarter of 2012, the proportion of deal volume involving infrastructure targets leapt to a 12-year high. This "secular trend" toward more infrastructure privatizations and transactions, adds Evans, also drove the relative increase in 3PL "deal value" and volume as a percent of the overall merger and acquisition market during the first quarter.

"Overall, logistics deal activity seems more likely to rise than fall given continued global economic expansion and the secular trend of rising infrastructure concessions," says Evans.

For 3PLs, adds Evans, consolidation will be an ongoing given, as more pure-play domestic companies seek to expand globally. "I can assure you that even the 3PLs found only on 'domestic' listings will at some point be hauling or arranging to haul freight globally," he says. "For those bigger companies seeking to expand worldwide, mergers and acquisitions can be an attractive way to proceed."

If one needed any more evidence of this phenomenon, consider the merger and acquisition activity of just a few months ago. UPS not only made a celebrated purchase of TNT Express, but went

Continued on page 48S

A&A's Top 50 Global 3PLs • May 2012

Rank	Third-Party Logistics Provider	2011 Gross Logistics Revenue (USD Millions)*
1	DHL Supply Chain & Global Forwarding	32,160
2	Kuehne + Nagel	22,181
3	DB Schenker Logistics	20,704
4	Nippon Express	20,313
5	C.H. Robinson Worldwide	10,336
6	CEVA Logistics	9,602
7	UPS Supply Chain Solutions	8,923
8	Hyundai GLOVIS	8,588
9	DSV	8,170
10	Panalpina	7,358
11	SDV/Bolloré Logistics	6,785
12	Sinotrans	6,769
13	Toll Holdings	6,432
14	Expeditors International of Washington	6,150
15	DACHSER	5,925
16	Geodis	5,890
17	GEFCO	5,267
18	Norbert Dentressangle	4,980
19	UTi Worldwide	4,914
20	Hellmann Worldwide Logistics	4,687
21	Agility	4,410
22	Yusen Logistics	3,881
23	Wincanton	3,507
24	Caterpillar Logistics Services	3,465
25	GENCO ATC	3,372
26	Kintetsu World Express	3,360
27	IMPERIAL Logistics	3,245
28	Damco	2,800
29	Hub Group	2,752
30	Penske Logistics	2,600
31	Pantos Logistics	2,412
32	Sankyu	2,341
33	Ryder Supply Chain Solutions	2,211
34	FIEGE Group	2,090
35	Kerry Logistics	2,060
36	Logwin	1,859
37	BDP International	1,800
38	Nissin Corporation/Nissin Group	1,647
39	Menlo Worldwide Logistics	1,590
40	Americold	1,580
41	APL Logistics	1,405
42	J.B. Hunt Dedicated Contract Services & Integrated Capacity Solutions	1,387
43	arvato logistics services	1,343
44	OHL	1,254
45	Landstar	1,219
46	Transplace	1,200
47	BLG Logistics Group	1,195
48	Werner Enterprises Dedicated & Logistics	1,087
49	Greatwide Logistics Services	1,046
50	NFI	1,014

*Revenues are company reported or Armstrong & Associates, Inc. estimates and have been converted to USD using the average 2011 exchange rate in order to make non-currency related growth comparisons.

on to buy Italian pharmaceutical logistics company Pieffe. Geodis, meanwhile, acquired French pharmaceutical logistics and distribution company Pharmalog. Then in a move to broaden its own pharmaceuticals footprint, DHL Global Forwarding acquired Lufthansa's 50 percent ownership in its joint venture company LifeConEx, a cold chain management provider in the life sciences industry.

In the Asia Pacific region, merger and acquisition activity was just as intense. Kerry Logistics acquired Trustspeed Medicine Logistics in Taiwan, and it also established a joint venture with Mosskito Logistics in Australia to expand its cold chain distribution segment.

Meanwhile, data from Armstrong & Associates—the third party logistics consultancy that compiles our annual top rankings of global and domestic 3PLs—shows that all of this global merger and acquisition activity certainly makes sound, business sense. In fact, Armstrong reports that total

A&A's Top 30 U.S. Domestic 3PLs • May 2012

Rank	Third-Party Logistics Provider	2011 Gross Logistics Revenue (USD Millions)*
1	C.H. Robinson Worldwide	10,336
2	UPS Supply Chain Solutions	8,923
3	Expeditors International of Washington	6,150
4	UTi Worldwide	4,914
5	Kuehne + Nagel (The Americas)	4,547
6	Exel (DHL Supply Chain - Americas)	4,100
7	DB Schenker Logistics (The Americas)	4,072
8	Caterpillar Logistics Services	3,465
9	GENCO ATC	3,372
10	CEVA Logistics (The Americas)	2,870
11	Hub Group	2,752
12	Penske Logistics	2,600
13	Ryder Supply Chain Solutions	2,211
14	Panalpina (The Americas)	2,134
15	BDP International	1,800
16	Menlo Worldwide Logistics	1,590
17	Americold	1,580
18	J.B. Hunt Dedicated Contract Services & Integrated Capacity Solutions	1,387
19	OHL	1,254
20	Landstar	1,219
21	Transplace	1,200
22	Werner Enterprises Dedicated & Logistics	1,087
23	Greatwide Logistics Services	1,046
24	NFI	1,014
25	Phoenix International Freight Services	1,000
26	APL Logistics (The Americas)	893
27	Jacobson Companies	892
28	Yusen Logistics (The Americas)	885
29	FedEx Trade Networks/FedEx Supply Chain Services	838
30	Agility (The Americas)	794

'*Revenues are company reported or Armstrong & Associates, Inc. estimates and have been converted to USD using the average 2011 exchange rate in order to make non-currency related growth comparisons.

global 3PL gross revenue in 2011 at $133.8 billion was up 5.2 percent over 2010. Furthermore, net revenues, at an estimated $61 billion, posted a 5.9 percent annual gain.

EU blues

Given that most of the mega 3PLs are based in the European Union, economists are suggesting that Darwinian tendencies will prevail and the smaller companies will be acquired before the year is out.

"Hopefully, easing inflation, improving global growth, a relatively competitive Euro, and containment of Eurozone sovereign debt tensions will help the economic activity stabilize in the second half of 2012," says Howard Archer, IHS Global Insight's chief European economist. "But much will depend on events in Greece and their repercussions."

IHS currently forecasts Eurozone GDP to contract by around 0.5 percent overall in 2012, and economists fear that renewed contraction is very much in the cards for the second quarter. In its most recent survey of purchasing managers, the evidence has been largely disappointing.

"The Eurozone is still facing major headwinds, including increased fiscal tightening in many countries and markedly rising unemployment," says Archer. "Elevated oil prices have kept inflation sticky, maintaining a significant squeeze on consumer's purchasing power while also hurting companies' margins. On top of this, relatively muted global growth is limiting export orders."

It is worth noting, however, that despite global economic concerns, mergers and acquisitions within the transport and logistics industry remained strong, as the number of deals increased almost 5 percent through the third quarter of 2011 compared to same period in 2010.

According to Transport Intelligence (Ti), a London-based think tank, the current global total deal value in 3PL and contract logistics compared to 2010 is down by almost 40 percent. "This suggests that smaller, more specialized logistics providers appear to have been targets of acquisitions throughout 2011," says Ti analyst Cathy Roberson. "The majority of the acquisitions made were in Asia and other emerging markets; however, the European and the U.S. merger and acquisition market remained fairly strong."

Leading academic experts say much the same thing about global 3PL resiliency. For John Langley, clinical professor of supply chain management at Penn State University, the fact that so many major players remain in the mix at all is testament to the strength of the sector.

"It's clear that contract logistics is a global business that can't be brought down by regional economic decline," says Langely. The process of outsourcing product flow management, storage, and related information transfer services—usually under long-term contract—remains the objective of increasing efficiency and control no matter where it's being done."

Modest growth forecast

Principals at Armstrong & Associates maintain that growth in the sector will be sustained, but sluggish. "After surveying our 3PL tracking group and seeing the final 2011 results, our initial estimate of 12.9 percent growth in the international transportation management [ITM] segment has been revised down," says consultancy president Evan Armstrong. "With the European economy in decline and Asia cooling, ocean freight revenues expanded slightly, but could barely counteract the decline in airfreight revenues."

Despite global economic concerns, mergers and acquisitions within the transport and logistics industry remained strong, as the number of deals increased almost 5 percent through the third quarter of 2011 compared to same period in 2010.

Armstrong notes that this is more of a continuation of 2010, with domestic transportation management doing well and the value-added warehousing and distribution segment remaining steady. "Beyond that, dedicated contract carriage, which is the most mature of the 3PL market segments, should be able to grow 4 percent as providers keep a lid on capacity and manage fleet asset additions."

At the same time, Armstrong expects ITM net revenues to grow 3 percent in 2012. Domestic transportation management should continue to lead the way, with approximately 10 percent net revenue growth this year.

"It's a good time to be an integrated 3PL with business in multiple 3PL segments," says Armstrong. "Most large 3PLs have internal lead logistics

providers [LLP] groups that tend to focus on process re-engineering, continuous improvement, and information technology deployment for improved 'control tower' supply chain management."

Part of Armstrong's forecast also suggests that most global 3PLs will conduct modal shifts away from airfreight and express modes to lower cost transportation alternatives to save money through the tepid economic recovery. "Tighter inbound transportation control and overall network optimization means that providers that can meet the required service standards will continue to be the 3PL leaders," he adds.

This may explain why there was no change among the seven leading global 3PLs in this year's ranking. Like 2011, DHL Supply Chain & Global Forwarding leveraged its extensive integrated global footprint. Armstrong says that Kuehne + Nagle is still the largest "pure" ocean freight forwarder with over 2.9 million twenty-foot containers (TEUs) managed in 2011.

"C.H. Robinson Worldwide continues to expand globally and has added operations in Mumbai and Shanghai," says Armstrong. "While still growing, one must remember that only 8 percent of Robinson's revenues are derived outside of the United States."

Advancing companies include Norbert Dentressangle, which is continuing to expand beyond Europe, and Toll Holdings, which has expanded its Southeast Asia operations and overall global network. Armstrong says that Agility has had the most dramatic decline, dropping from number 16 to number 21 mainly due to past legal complications with U.S. government clients.

3PL markets demonstrate strong, consistent growth

Below are a few noteworthy details from Armstrong & Associates latest 3PL market report:

- **Domestic transportation management gross revenue at $41.3 billion was up 12.2 percent year-over-year, and net revenue at $6.3 billion was also up 12.2 percent year-over-year.**
- **International transportation management gross revenue at $46.1 billion was up 0.8 percent year-over-year, and net revenue at $17.7 billion was up 2.1 percent year-over-year.**
- **Dedicated contract carriage gross revenue at $11.1 billion was up 4.7 percent year-over-year, and net revenue at $10.9 billion was up 4.7 percent year-over-year.**
- **Value-added warehousing and distribution gross revenue at $34 billion was up 8.2 percent year-over-year, and net revenue at $26.6 billion was up 8.4 percent year-over-year.**

Emerging markets

Dick Armstrong, who shares the consultancy's role as president, says that some of the companies resting at or near the bottom of this year's Top 50 Global 3PLs and Top 30 Domestic 3PLs are harder to quantify.

"All of the 3PLs listed have particular strengths in their specific markets," says the elder Armstrong. "Obviously, the euro-centric players are going to have a rougher time of it, given the sad state of their economy. On the other hand we see opportunity for 3PLs in Latin America, where Brazil is rapidly investing in its infrastructure."

But for those third party players that are not involved in China now, he says that it may be too late to gain a foothold. "In fact, we feel that more and more domestic Chinese forwarders will surface to become leading 3PLs in the future."

Angela Yang, managing director of the Asia-Pacific Region for Penske Logistics, also sees China as being key to any 3PL's global strategy. "With China experiencing rapid growth in the last 20 years, I would call this market 'dynamic,' but not yet mature," she says. "As a result, China is a very competitive place and pricing is key in many industries."

According to Yang, China-based manufacturers are constantly seeking low price providers. Because the logistics business environment is just so fragmented in China, and with lower prices constantly being offered, it's vital that 3PLs develop strong personal relationships with the customer.

Yang observes that the cost of labor is a relatively small percentage of overall logistics costs in China. The lion's share of expense is related to warehouse leasing, which can run anywhere from 50 percent to 70 percent. Equipment expenses are also considerable.

"In many cases, companies would rather hire additional people versus investing in equipment," says Yang. "Sourcing is vital to a 3PL's success in the Chinese market—leveraging resources, executing a lower

total cost solution, and providing great customer service is critical."

Encompass Global Logistics LLC, a fast-growing, privately-held 3PL serving shippers in North America and China, may well demonstrate how a "smaller player" can penetrate this burgeoning arena.

"Many 3PL's complement their ocean freight program with robust airfreight services and domestic distribution services in China," says Encompass CEO Asa Cheng. "The collective service menu puts many 'smaller players' on par with those giant multinationals."

Secondly, says Cheng, the smaller player can be more flexible in offering premium service from the inception of the purchase order to the shipper's door. He notes that the 3PL has the ability to negotiate volume across multiple carriers and utilize those carriers whose services best complement the needs of specific shippers.

"We can work the spot market for our accounts, as we are on the forefront of market-driven rate differentials by lane and by service," he adds.

Finally, says Cheng, many of the larger multinationals were kept busy during the recession, "strafing" clients with selling, general, and administrative expenses, which is a major non-production cost presented in an income statement.

"Instead of concentrating on short-term tactics, we should all be focusing on how to bundle customer-specific packages that address certain key elements of their supply chains," Cheng says.

Growing importance of IT

If any consensus can be arrived at with this year's special report on 3PLs, it's that all lead logistics providers—especially in emerging markets—should provide web-based systems that give importers and exporters complete and instant visibility to their shipments throughout the supply chain.

Penn State's John Langley may have summed it best by observing that emerging markets represent a "blank slate" when it comes to IT infrastructure: "Building information technology systems can be achieved more easily in a country like China because it's being done from scratch. Rather than adding on to legacy systems, or tearing one down to build another, 3PLs can now concentrate on putting the most modern solutions in place from the start."

In the end, the same can be said for airports, seaports, surface transportation networks, and everything else related to the expanding world of global logistics management.

—Patrick Burnson is Executive Editor of Logistics Management

Q&A: CEVA executives discuss Q1 results and global 3PL market

In early May, global third-party logistics (3PL) services provider CEVA Logistics reported first quarter earnings of $1.7 billion Euro or about $2.2 billion, which represented a 2 percent annual gain and down about 1 percent in constant exchange rates.

Pacing the quarterly growth was a strong performance by its contract logistics segment, which includes warehousing and dedicated transport, and saw revenues up 3 percent due to a strong showing from its North America- and Asia-based automotive group. The company's freight management business, which is comprised of air, ocean, and customs brokerage, had flat revenues in the first quarter, while ocean and airfreight results were mixed.

Logistics Management Group News Editor Jeff Berman sat down with CEVA CEO John Pattullo and CFO Reuben McDougall to discuss the company's quarterly results as well as the market trends that are driving the global 3PL sector.

***Logistics Management:* What is your take on CEVA's first quarter performance?**

John Pattullo: Overall, I would describe the quarter as challenging both for the industry and for CEVA. However, in our view, it was more good than bad regarding CEVA's quarterly results. Our revenue and our profit performance were relatively strong compared to our peers. That has to do with the structural changes we made in 2011, with our Project Uno for global standard processes in freight

management, back office outsourcing in the finance area, and leveraging our scale in global operations.

These changes have helped to make the company more robust. We also have a well-crafted and very specific game plan for 2012. In this big and complex logistics market we live in, it's really easy to be a "busy fool" and chase all sorts of false possibilities. It's our job to be focused and deliver for our customers.

***LM:* What's the current contract logistics environment like in Europe and Asia?**
McDougall: Northern Europe has been performing well for us and it is not a drag on our performance level. Southern Europe, including Spain and Italy as the biggest pieces, have been weak because of its local economies, while some other markets like Asia and Turkey have been strong.

***LM:* What is your take on the ocean cargo business?**
Pattullo: We're seeing a market that is still growing globally by 4 percent to 5 percent, which is good, and we have seen some fairly significant rate increases from carriers in the March and April timeframe. Those have not had any material impact on CEVA because we had secured longer-term pricing with our customers and those recent rate hikes have not affected them.

In the industry, there is a debate as to whether these recent rate hikes will take hold. The reason is that there is a lot of new capacity coming into the industry, and March was the biggest addition of container ship capacity in a very long time. More capacity is entering the market at a faster rate than the industry is growing.

***LM:* How are things on the air cargo side?**
Pattullo: Unlike things on the ocean side, air cargo growth is still negative. The global air market is down roughly 2 percent annually. The industry view is that there might be some sort of upturn in the second half of the year, with volumes up by maybe 2 percent. That would make things flat for the year. It is a doldrums type of market, and since 2009 there has been more moves by shippers to trade down modes and use alternatives to air.

***LM:* As the mid-year point approaches, how do things in the global 3PL market compare to things a year ago at this time?**
Pattullo: Overall it's a pretty flat global market. Air is down, and ocean is up. There is more buoyancy in the U.S., which is good news, but on the other hand things in China have slowed down somewhat in the last year. If you aggregate the global situation—and we are operating in markets that are essentially flat—our game plan is that we need to grow share in those markets. As part of our shared growth campaign, we are focused on growing our share of airfreight and winning more big accounts.

"Customers these days are much more interested in the value proposition of their end-to-end supply chain than they are with the pure pricing of any competitor within the supply chain. "

—John Pattullo, CEO, CEVA

***LM:* How is the current pricing environment as it compares to growing market share?**
Pattullo: Customers these days are much more interested in the value proposition of their end-to-end supply chain than they are with the pure pricing of any competitor within the supply chain. Our *modus operandi* is to look at the end-to-end supply chain and find value for our customers.

There is plenty to go after, which allows us to give customers value while getting a reasonable margin. Historically, buyers have been more siloed and commoditized in their thinking; and in our case, 54 percent of our total business comes from our 100 biggest accounts, which are comprised of sophisticated multinationals looking at a true end-to-end proposition. That said, there are still opportunities for pricing.

***LM:* CEVA recently submitted documents to the SEC to be floated on the New York Stock Exchange regarding its desire to raise share capital. Is there anything you can comment on regarding that?**
McDougall: Basically, what I can say is that this is a step that opens the possibility of an IPO down the line. It's an administrative step required to have an option to do a listing. It's not a commitment to do a listing, nor is it a comment on the size of the listing or the timing. It is just an administrative step and there is no timeframe for it.

***LM:* Even with the recent decline in U.S. diesel prices, prices are still high. That said, sustainability is becoming a hot topic again. Where do you think sustainability stands in the market?**
Pattullo: It's very important. Our philosophy at CEVA is that we want to be driven by good science because there can often be less than rigorous claims and data floating around at times. We believe there should be a business case for most environmentally driven projects, because the environmental benefit will in turn present a business benefit.

We have a good environmental program. Some of the key elements include having invested heavily in southern Europe in environmentally neutral or positive warehousing, where we are generating electricity from photovoltaic panels and recycling everything we can. We also offer a carbon footprint monitoring service for our top 100 accounts where we help them calculate their footprint. And we are also collaborating with a diesel engine manufacturer to test and develop fuel-efficient modes of operation.

***LM:* What are you hearing from shippers when it comes to collaboration?**
Pattullo: Customers increasingly expect us to be able to offer the same system, the same service, and the same KPIs across the globe. They want a 3PL that can give them a consistent global product, and due to compliance, control, or cost reasons they want to have that level of consistency. That has been a key message.

At the time of the Thailand floods last year, we tracked what was happening in the affected markets in great detail for our customers and provided that information quickly for our customers and worked with them to find solutions to problems caused by about 14,000 factories being affected. What customers liked in that situation was that they were able to provide them with data and knowledge. They don't just want to hear we have delivered a shipment; they want information through the supply chain.

They also want historic data and KPI performance, with an increasing expectation of data from global 3PLs.

— Jeff Berman, Group News Editor

Roadrunner Transportation Services acquires D&E Transport

Acquiring companies is nothing new for non asset-based third-party logistics services provider Roadrunner Transportation Services (RRTS).

The Cudahy, Wisc.-based company announced last month that it acquired all of the outstanding capital stock of Clearwater, Minn-based D&E Transport, an asset-light flatbed carrier focused on food and agricultural products.

RRTS officials said the purchase price was $11.2 million plus an earnout, adding that it was financed with borrowings under Roadrunner's credit facility. RRTS officials were not available at press time for additional comment. D&E had 2011 revenues of roughly $23.8 million, and the company hauls full load and LTL freight from coast to coast.

"The acquisition of D&E broadens the service offerings within our truckload and logistics business segment and expands our flatbed capacity and customer base," said Mark DiBlasi, CEO of Roadrunner. "D&E has built solid, long-term customer relationships and brings superior service and safety records to Roadrunner. D&E's principal former owner and experienced management team will remain in place and are excited about the growth opportunities we collectively envision."

This is the sixth acquisition RRTS has made. In February, the company announced it acquired all of the outstanding stock of Nashua, N.H.-based Capital Transportation Logistics (CTL), a transportation services management provider, for $6.25 million.

In September 2011, it acquired Prime Logistics Corporation, a non-asset based provider of logistics and freight consolidation. In February 2011 it acquired Morgan Southern; in May 2011 it acquired Wichita, Kansas-based truckload services provider Bruenger Trucking Company; and in July 2011 it acquired The James Brooks Company, a provider of intermodal transportation and related services for the ports of Los Angeles/Long Beach and Oakland.

— Jeff Berman, Group News Editor

3PL Outsourcing governance: Why insight beats oversight

Outsourcing to a 3PL has been a boon to many. Yet in numerous cases the arrangement fails to live up to its real potential. One recurring problem: the lack of a proper governance structure. When done within the context of a mutually beneficial "Vested Outsourcing" relationship, good governance can help both parties succeed.

By Kate Vitasek, Jerry Stevens, and Katherine Kawamoto

For many years, companies have looked to outsourcing as a way to reduce costs and increase supply chain productivity. But according to studies by the Corporate Executive Board, up to 90 percent of the value of an outsourcing deal can be eroded because of poor relationship governance. The Outsourcing Center, an internet site for supply chain thought leadership, agrees. The center reports that poor governance plays a role in outsourcing failures as much as 62 percent of the time. The value erosion or "savings leakage" that can result from poor governance is, in fact, a pressing problem for companies today.

Proper governance in an outsourcing arrangement is critical because the supplier or service provider becomes an extension of the company doing the outsourcing. A sound governance structure provides consistent management along with cohesive policies, processes, and decision rights that enable parties to work together effectively and collaboratively over the life of the agreement. Perhaps most importantly, good

governance maximizes the potential for successful contract implementation.

We'll explore the nature of good governance within the context of Vested Outsourcing, a concept that is being researched and advanced through work at the University of Tennessee. Through Vested Outsourcing and its Five Rules, the parties work toward mutual success based on optimizing for innovation and improved service, reducing costs to the buying company, and improving profits for the outsource provider. A good governance structure supports these goals. UT researchers studied highly successful outsourcing relationships and found that all followed a basic governance tenet: the company outsourcing embraced "insight vs. oversight" in how it worked with the supplier to manage the scope of the outsourced services. In fact, the fifth rule of Vested Outsourcing says that governance structures should provide insight into the outsource relationship, not merely oversight or bean-counting.

UT researchers teamed with the Corporate Executive Board and the International Association of Contract and Commercial Management to develop a framework for sound governance of outsourcing agreements that adopt a mutually beneficial "Vested" model. The framework consists of these three elements:

1. Relationship Management—This element formulates and supports joint policies that emphasize the importance of building collaborative working relationships, attitudes, and behaviors.

2. Transformation Management—Vested agreements are transformative because change in this environment is desirable and expected. This change needs to be managed during and after the transition from old to new.

3. Exit Management—The future is unknown. Even the best-conceived plans may fail and unforeseen events can completely change the business environment. An exit management component of the governance structure provides procedures to handle these unknowns.

Exhibit 1 summarizes these three elements of a Vested governance structure—which is founded on an "insight" mentality—and compares these with traditional arrangements built on "oversight." In considering the key elements, it's important to remember that there is no secret sauce that magically creates a Vested governance structure. There's no one-size-fits-all approach.

The following sections discuss the principal elements of sound governance in a Vested outsourcing relationship.

EXHIBIT 1

Three Elements of a Vested Governance Structure

Element	Vested Mentality—Insight	Traditional Mentality—Oversight
Relationship Management	• Relationship management focus. • Reverse bow tie structure, layers. • Joint policies that emphasize collaborative working relationships, attitudes and behaviors.	• Service provider management focus. • Bow tie structure. • Agreements viewed as risk avoidance mechanisms that monitor transactions/functions.
Transformation Management	• Agreement components viewed as a flexible framework. • Regular contact/review systems for service, performance, IP, and IT updates; joint review boards for potential agreement changes and service issues. • Focus on performance and transformation. • Emphasis on end-to end business metrics as well as service provider SLAs. • Mutual accountability for desired outcomes; focus on root cause analysis. • Ecosystem that encourages and rewards innovation.	• Agreement components viewed as fixed. • Infrequent communication or only when emergencies arise. • Little or no provisions for regular reviews beyond monthly revenue/cost accounting reports. • Focus on service provider metrics and scorecards • Narrow SLA focus on the service provider SLA targets; focus on reporting. • No clear systems that set joint processes for innovation as a continuing culture beyond "feel-good" PR.
Exit Management	• Addresses how to handle future unknowns. • Based on fairness. • Seeks to keep parties whole in the event of a separation that is not the result of poor performance.	• Focus on Ts and Cs that are risk averse. • Entity with the most power typically uses that power to negotiate in their favor without regard to fairness.

Element 1: Relationship Management

This core element establishes the mechanisms for managing the relationship and the business. Importantly, it also covers how the parties address changes in the agreement itself—and changes will inevitably happen. In our view, relationship management is mainly about operational alignment, the process by which the parties arrange the people and systems to manage the outsourcing agreement. We've identified

six techniques for aligning organizations, each of which is discussed more fully below.

WIIFWe (Vested)	WIIFMe (Conventional)
Finding a way to meet both our needs.	Getting the service provider to meet our needs.
Work together to achieve the performance and compensation goals.	"It's in the agreement; now it's the service provider's problem."
Communicate the issues, jointly find solutions.	Blame and punish the service provider.
Integrated planning and communications.	Unpleasant surprises.

Many companies that outsource believe they have achieved the necessary alignment simply because they have deployed Service Relationship Management (SRM) techniques. SRM is the practice of creating mechanisms to increase the efficiency and effectiveness in how a company works with its service providers to lower business costs. But SRM in and of itself is not enough. For true organizational alignment, SRM also needs to incorporate the Vested Outsourcing principle of win-win thinking. We call this WIIFWe, or "what's in it for we." This mindset is particularly important when developing processes to jointly manage the business to achieve desired outcomes.

The biggest difference between strategically managing a relationship and simply managing a service provider starts with the philosophy of how the parties work together. The table to the left contrasts the relationship management approach (WIIFWe) with conventional management of a service provider (WIIFMe, or "what's in it for me"). A Vested governance structure embeds WIIFWe thinking into each SRM best practice.5

With that Vested WIIFWe mindset firmly in place, companies can pursue six key actions that lead to real organizational alignment:

1. Create a tiered management structure for governance. A tiered management structure is a layered approach, with each tier having specific responsibilities for managing different aspects of the business. This approach creates vertical alignment among upper management, mid-management, and day-to-day workforce. Each layer is responsible for advancing the outsourcing relationship to achieve business success through its respective "lens." Each layer also works to make sure that the relationship is focused not only on the tactical elements, but also on the strategic and transformational components.

We recommend a three-tiered organizational framework, as illustrated in Exhibit 2. This three-tier layered governance structure can work well in almost any type of Vested relationship. It ensures that the organization is receiving guidance in a timely and consistent manner from three key perspectives: functional working levels, operational level, and executive level. The tiered structure also facilitates decision making. When an issue cannot be resolved at one level, it can be readily escalated to the next level of the framework.

2. Establish service delivery, transformation and commercial management roles. A Vested agreement by design is meant to drive transformation; accordingly, a governance structure needs to promote and drive transformational efforts.

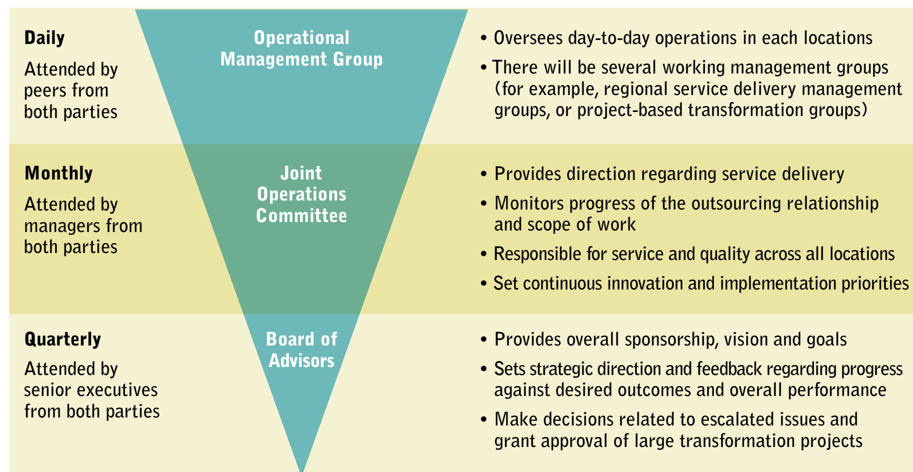


EXHIBIT 2
Tiered Governance Structure

This activity falls into three primary governance roles: service delivery management, transformation management, and agreement compliance.

Each governance role is outlined below:

• *Service Delivery and Management.* This role focuses on the efficient delivery of service, responsiveness to customers, and ensuring that service delivery complies with regulatory and internal policy requirements. The size of the group managing this will vary according to the size of the deal, but is preferably limited in number. For example, a large global outsourcing deal might have six people dedicated to service delivery management—with a full time person from both the buyer and supplier being responsible for three regions (North America, Europe/Africa, and Asia).

• *Transformation Management.* This role drives ideas, innovations and process changes across the parties. The size of this group will also vary according to the deal size.

• *Commercial and Relationship Management.* This role manages the commercial and contractual aspects of the outsourcing relationship as well as the overall relationship across the various stakeholders in the two organizations.

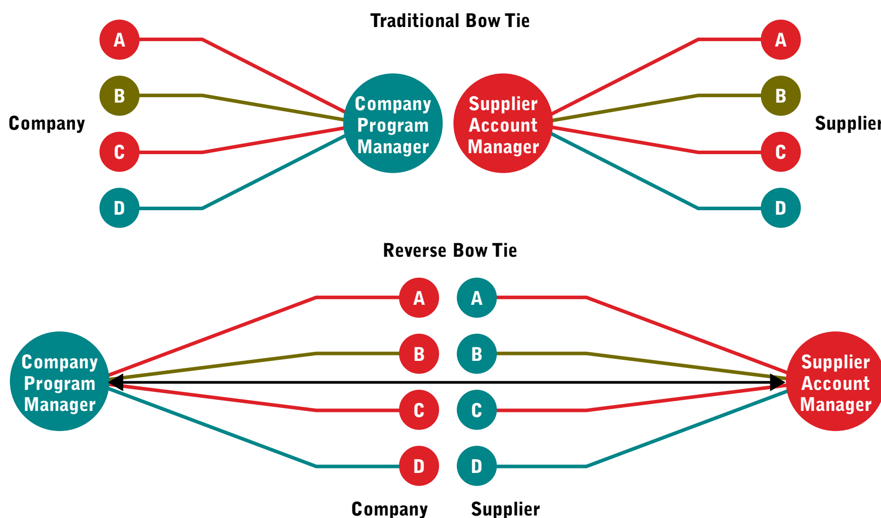
These functional governance roles are included in the governance framework that the parties agree to. Ideally, the governance structure is formally included into the actual contractual agreement.

3. Adopt peer-to-peer communication model. After establishing the tiered structure and the various functional roles within that structure, the parties should focus on horizontal integration. One way to do this is through mapping the various individuals involved using a peer-to-peer alignment approach commonly known as a "reverse bow tie." (See Exhibit 3.) Many companies insist on using traditional hierarchical structures in which everything flows through the outsourcing company's program manager and the service provider's account manager. This approach is depicted on the top half of Exhibit 3 as a "traditional bow tie" model.

We recommend direct functional communication through the appropriate contacts in the respective organizations—that is, the reverse bow tie approach as shown on the bottom half of the exhibit. Using this approach, managers of specific aspects of the outsourcing agreement take responsibility for keeping the company's program manager and the service provider's account manager informed. This communication model improves the flow of information and helps to empower company and service provider teams.

4. Develop a communications cadence. Establishing a regular cadence of communications is an important aspect of the governance structure. Such a cadence is the "rhythm of the business." It puts in place a practical mechanism to help the parties manage the business. As with any collaborative endeavor, regularly scheduled conference calls, team meetings, and face-to-face formal reviews are the grease for the wheels. Governance involves free-flowing communication between operational groups, their managers, and the companies' executives. The most successful teams have formal mechanisms (and informal protocols) for talking on a daily, weekly, monthly, quarterly and annual basis.

5. Develop a process to maintain continuity. One of



the most often-heard pushbacks from organizations contemplating Vested Outsourcing is, "I love the concept, but what if we sign up for risks under the agreement and the players change and throw out the rules? The pendulum swings and any progress we have made through our trusting relationship is lost."

This is a real fear. To help allay it, the governance framework should contain a process for ensuring employee continuity. Here are some best practices:

• Mutually identify a limited number of personnel that are designated as "key personnel" for both parties.

• Establish a provision that prevents either party from removing, replacing, or reassigning key personnel during an established timeframe. Two to three years is a reasonable duration that still enables individual promotions.

• Develop a process for communicating key personnel changes. For example, establish communications protocols when key personnel become unavailable because of sickness, jury duty, resignation, and so forth.

• Establish a process for promptly replacing key personnel.

• Use a formal escalation process for personnel issues. For example, in some cases one of the parties (typically the company outsourcing) might have employees that denigrate or verbally abuse the service provider's personnel. This is intolerable. The agreement should have provisions that address such improper behavior between the parties or between employees.

6. Establish a performance panagement program. Vested Outsourcing isn't just about implementing an innovative program. It's also about governing a day-to-day business relationship. Thus, a performance management program must be established that:

• Measures end-to-end performance against KPIs and desired outcomes, not just service level agreements (SLAs).

• Provides a mechanism to measure the overall health of the relationship and effectiveness of transformation efforts.

• Enables the parties to "score" performance to identify any shortfalls.

• Includes a neutral third party to help facilitate decisions on final performance scores and other aspects of governance.

• Includes a proactive problem-solving and dispute resolution process.

Element 2: Transformation Management

A successful Vested Outsourcing agreement needs transformation management processes in place to help the organization stay aligned. This is crucial because the one constant in a dynamic business environment is change. And change can put pressures on even the steadiest of relationships. A Vested agreement establishes mechanisms to deal with changes in a way that will ensure that the organizations stay aligned and continue to work effectively together towards the desired outcomes. Specifically, the transformation management processes should allow the agreement to evolve in a controlled manner. It should support—not hinder—continuous improvement and innovation.

The biggest difference between strategically managing a relationship and simply managing a service provider starts with the philosophy of how the parties work together.

The transformation management element of an agreement should contain four components, each targeted at a different aspect of the transformation:

1. It should clearly and comprehensively document how the initial transition of work will be managed. This ensures that the relationship gets off to a good start by establishing clear parameters.

2. It should include philosophies for driving overall transformation initiatives—called a continuous innovation management process. This part of the agreement sets the protocols and processes outlining how the company will manage ideas that both parties need to agree to and invest in order to achieve their desired outcomes.

3. The agreement should contain a process for managing day-to-day continuous improvement efforts as well as any problems that arise.

4. It should include a process for updating and managing changes to the actual agreement.

Only by establishing clear protocols and processes for each of these elements will the organization achieve maximum effectiveness as it drives transformation.

The Initial Transition

The agreement may represent a transition from a company-operated function to a new service provider or from an old service provider to a new one. Or it may simply entail a scope change and a new way of doing things in an existing relationship. If there is considerable work scope shifts in an existing relationship, the Vested agreement should formally describe how each party will manage the transition by including the following three essential activities associated with the initial transition process.

• Maintain team continuity from the initial sourcing process through transition to day-to-day operations.

• Develop an effective communication and training campaign around the transition, including a formal "blueprint" of the work to be done. This ensures that the key work scope elements are transferred and the appropriate resources are established.

• Create a high-level target plan. Though some of the operating details likely will change, the Vested agreement requires a high-level transition plan agreed to by the parties. The plan will include assumptions, milestones, key dependencies, performance criteria, quality control and delivery management procedures. In addition, the plan will address requirements around testing methodology and transition project management protocols such as progress reviews and issues resolution.

Continuous Innovation Management

If it is to achieve its real potential, a Vested Relationship cannot be static. For this reason, the agreement should include formal processes for managing ideas, opportunities, and innovations that can help the parties achieve their desired outcomes.

A Vested Outsourcing agreement rewards service providers for innovative ideas and investments that deliver results against the desired outcomes. Innovation in products and processes is critical—in fact, it's the key driver of economic growth for businesses. Nobel Laureate Robert Solow found that 87 percent of all business growth comes from technological innovations.6 Establishing a joint continuous innovation management process, therefore, is a fundamental part of a Vested agreement. The process should detail exactly how the parties will communicate and make investment decisions with regard to potential innovations that can help both parties achieve the desired outcomes.

Continuous innovation management relies not only on the parties' ability to collaborate and generate ideas, but also on their ability to implement ideas that can deliver value. The problem here generally isn't a lack of ideas; it's their execution. So we recommended developing a mechanism for "scoring" projects by value so as to identify the top candidates for continuous innovation.

In creating an innovation management process, keep the following suggestions in mind:

• Keep ideas in an "innovation pipeline." Just because an idea was rejected once, that doesn't mean it cannot be revisited and reevaluated in the future.

• Track how many ideas are generated relative to how many get implemented. The best companies will implement a large number of ideas—as much as 90 percent of those identified.

• Develop a Pareto chart7 of reason codes as to why ideas do not get implemented.

Specifically, the transformation management processes should allow the agreement to evolve in a controlled manner. It should support—not hinder—continuous improvement and innovation.

• Clearly document desired hurdle rates for proposed idea/projects and create a formal process that teams can use to help them capture and quantify their ideas.

• Develop a decision framework and process for selecting ideas to implement.

Continuous Improvement Program

The third transformation management component is a continuous improvement program for managing day-to-day operations. These programs are different from continuous innovation management, which tends to focus on larger-scale transformation initiatives that likely need investments or resources.

Continuous improvement programs often are cross-organizational in nature and are tied to the desired outcomes. These initiatives come in all forms—Six Sigma and Lean being two of the most popular. Regardless of the particular program adopted, it should have the following attributes: jointly adopted (not a one-party program); transparent fact-based decisions; end-to-end focus

on accountability; customer satisfaction surveys (including external customers and end users); and formal benchmarking reports.

Change Control Procedures

The agreement should have change control procedures that are used to request, assess, process and approve, or reject modifications to the agreement. The parties adopt a written change request process that is used to initiate a formal change to the agreement. A change request is required for modifications that affect the price or related costs of the services, impact the delivery of the service, or impact the obligations of either party under the agreement.

Typical events that trigger change requests can include:

- Changes in applicable law that have a material impact on the services.
- Introduction of new or updated technology tools.
- Changes in volumes not included in the agreed upon pricing.
- Changes in work scope not included in the agreed upon pricing that will require additional staffing or costs.
- Changes to service-level targets.
- Changes in key personnel.
- Requests for additional work for one-time projects that will require additional staffing.
- Changes in assumptions outlined in the pricing model.

Element 3: Exit Management Plan

Because nothing lasts forever, the governance framework should address this critical question: What happens when the agreement ends?

If the agreement is properly structured and is achieving the desired outcomes while continually improving performance, renewal of the contract is likely. Yet sometimes relationships can fail no matter how promising the start, how well intentioned the parties, or how carefully the objectives are identified. Business and market conditions can change suddenly; people move on; projections fail to pan out and companies change hands. An important facet of the governance framework, therefore, is a credible exit management plan.

One of the potential dangers of outsourcing is that a company becomes so entwined with and dependent on the service provider that it believes the pain of terminating the agreement outweighs the potential benefits of changing providers. This happens most often when service provider management becomes service provider abdication. By maintaining a Vested mindset and emphasizing balance in the company-service provider relationship, two good things happen: (1) the likelihood of the partnership degrading becomes less and (2) the process of dissolving the partnership if circumstances dictate becomes more straightforward.

An exit management plan will facilitate a smooth, effective transition of services delivery with minimum disruption of ongoing operations. The plan also will result in the efficient completion of all agreement obligations. The exit management plan typically is invoked with the issuance of a formal termination notice under the agreement, specifying:

- The portion of services included in the scope of termination.
- The estimated exit transition period and vendor services affected.
- Following a termination notice, a timetable for the specific scope of transition services.

A summary of the components of an effective exit management plan follows.

Termination notice. The exit management plan takes effect when a formal termination notice is delivered by either party or when services are transitioned once the agreement or work scope expires. The termination notice must be specific about the services affected (including processes and geographies). The notices also must include or identify an estimated exit transition period; service provider delivery centers affected by the transition; the location of replacement delivery centers; and vendor transition assistance charges.

Exit transition period. Just as there is a transition period when an outsourcing agreement is first implemented, there is a transition period in the event of agreement termination. This period generally will run from the date of the termination notice to the date upon which any transition services are completed.

Exit transition plan. The objective of an exit transition plan is a smooth, effective, and uninterrupted transition of service delivery with a minimum of disruption and efficient completion of all obligations under the agreement. This can only

happen if there is a plan to make it happen—and if the plan is managed through an exit management process that is established within the agreement's overall governance structure. A dedicated manager should be named to supervise the exit management team

Governance and reporting. The exit management process should be managed within the overall governance structure developed as part of the agreement. The exit transition plan should address any issues arising from the termination of services and should specify reporting requirements. If the exit transition period is short (under 60 days), daily or weekly reporting to the exit transition team is advisable. The exit management plan will provide a sort of reverse view of the entire governance framework, in essence outlining the vital steps to "unwind" the relationship.

Collaborative Governance Structure

Governance is largely unchartered territory for outsourcing contracts—often ill represented in the contract or omitted altogether. Yet the lack of a proper governance structure is one of the main reasons that agreements sputter or fail. All outsourcing agreements should include governance as part of their formal agreement. Formalizing and documenting a joint governance process will help the parties work effectively together after the contract is signed.

Our work has shown the most effective governance structures are those that are built on providing insight, and not merely oversight of the supplier. We call this approach a Vested governance structure because in managing the relationship a company and its service provider have a vested interest in each other's success. A good Vested governance structure encourages the parties to work together for mutual benefit by creating three interlocking and overlapping structural, flexible and collaborative elements—relationship management, transformation management, and exit management. The framework and the three elements provide the roadmap to help companies implement the core Vested Outsourcing principle that a collaborative governance structure should be based on insight rather than oversight.

We hope this article has helped to provide a sound framework for governance, allowing you to put the concept of governance into practice. □