(Source: Interview case from McKinsey Round I, 2006)

Context
Our client is Granite Investments (financial services company) in the US. It used leading-edge technology in it business. A few years back, since the client did not want to invest more capital into the IT systems and decided to outsource it (hardware and support) to a US-based company called Apolgee. The CEO of the client feels that they are being overcharged for the outsourcing services and hence are wondering what they should do. McKinsey has been hired to help them.

Interviewer: Why do you think the outsourcing costs are high?

A good answer will identify the following reasons:

- Our client pays high price because there are few good outsourcing companies available so the good ones including Apolgee demand high price.
- Our client pays high price because they have specialized or complex systems and cutting edge technology that require specialized services and support. Apolgee is a premium service provider with specialized knowledge and skilled labor.
- Our client requires high service level and therefore has to pay a premium for it.
- Apolgee charges our client high fee because Apolgee has high cost structure. For example, Apolgee might not have economies of scale and therefore pay high price for their components.
- If the service is charged per transaction, our client could have too many transactions due to system complexity or process inefficiency.

Interviewer: Following data provided upfront and candidate was asked to calculate the margin of Apolgee. Apolgee pays for all hardware and support required.
- **Number of employees = 2000 (every employee owns a PC)**
- **Cost/PC = $1200**
- **Cost of each support person who is needed to service computer/year = $60,000**
- **General maintenance cost/PC = $200**

Other data provided only when asked:
- **Price that client pays/yr = $2.4M**
- **Replacement policy of computers = replaced every 4 years**
- **2 support people needed for every 200 computers**

Interviewee should do the following calculation:

Total costs
1. Cost of PCs = Price/PC * No. of computers needed every year
   = $1200 * 2000/4 = 0.6M
2. Support cost of people = Support staff's salary/year * No. of support staff needed
   = 60,000 * 2000/200 = 0.6M
3. General maintenance cost = Cost/PC * No. of PCs
   = 200 * 2000 = 0.4M

Total costs/year for Apolgee = 0.6 + 0.6 + 0.4 = $1.6M

Margin = Profit/Revenue = 2.4M-1.6M/2.4M = 33.33%

Interviewer: What do you think about the margin?

Interviewee: The margin seems very high for the IT industry.

Interviewer: Yes – in fact it is very high for this industry. How can the client do to decrease the price?

A good answer will identify the following options:

- Increase the number of year you use a PC (to 5 years)
- Use less PCs (<2000)
- Buy cheaper computers (or have a lease with computer manufacturers)
- Have a lower service level requirement (so you do not need 10 support people)
- Ask Apogee to hire cheaper technicians for them
- Do competitive benchmarking to see if you can use another vendor (need to ensure that you can break the existing contract) – even outside the US

Interviewer: Great. OK, one of the systems that they have outsourced is the website. Now, Apolgee has proposed that the client increase its service level from 99% to 99.9% for $5M/year. Should they do it?

Interviewee: It will depend on whether doing so is profitable to our client. Our client can estimate the incremental revenue due to increased service level and compare that to the incremental cost ($5M).

Data only provided when asked

- **Number of total transactions on the website/year = 200M**
- **80% - general inquiries (although these might impact brand etc., and lead to more revenues – but we will ignore that for now)**
- **20% - revenue generating**
- **Average revenue/transaction = $30**

Interviewee should calculate the following:

Total revenue from the website (if 100% service level i.e. no transactions are lost)
= 0.2 * 200M * $30 = $1200M

If they gain 0.9% of the transactions that they now lose = 0.009 * $1200M= $10.8M

By increasing service level by 0.9%, the client gains $10.8M. If they have to pay Apolgee $5M, they would still make a profit of $5.8M (assuming no other costs). Hence, they should increase the service level as suggested by Apolgee.

Interviewer (Role-Play): Imagine I am the CEO of Granite Investments. I am very frustrated with the Apolgee – that their prices are so high, and now they are asking me to pay another $5M. As a McKinsey associate on this project, I look to you for help. What would you tell me?

Interviewee: Mr. CEO, we analyzed Apolgee's proposal to increase the service level to 99.9%. Our analysis shows that by getting the extra 0.9% revenue generating transactions you would gain $5.8M in profit. Therefore, we recommend that you take the deal. In addition, because Apolgee's profit margins seem very high at 34%, in the next a few days we would like to do some competitive benchmark analysis to see if other vendors offer better prices with the same level of services to see if we are overpaying Apolgee. If yes, we can renegotiate contract terms with Apolgee or switch to other vendors. Of course, we need to review the contract to see if there are any restrictions we should be aware of. If we want to switch, we need to assess the impact of switching cost.

Interviewer: In fact, Apolgee has agreed that we can break the contract anytime we find better prices outside.

Interviewee: Great! Then we shall do the benchmark exercise and see if we can find better vendors.