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# **Outlook for the Global Outsourcing Industry for 2009**

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As we enter 2009, there are three overarching topics that have achieved prominent status on the strategic agenda for outsourcing considerations. The terrorist attacks in Mumbai of December 2008, while not targeted at Western business interests, caught the distinct attention of business executives who are dependent upon the India-based information technology (IT) and business process outsourcing economy. To the anxiety regarding the threat to physical well-being one must add the fuel of the recent scandal regarding Satyam, India's fourth largest service provider. The scores of corporations that rely upon Satyam for supporting their business operations enter the year scrambling to understand how to mitigate the risks relating to Satyam's viability.

Finally, these events are framed by the ongoing global economic crisis. Most economists predict a long recovery period during which the stress of unemployment, debt market softness, currency volatility, and government intervention will prevail.

While the depth and extent of the current global economic crisis is not a topic for which we are equipped to predict the future, there are effects of the financial uncertainty and concerns regarding India-based outsourcing that are likely to be felt across the global outsourcing industry. We've tried to offer a few perspectives here.

## **BACKGROUND**

We first discussed the outlook for 2009 in 2007 when we released a depiction of trends and implications called ***The Global Outsourcing Industry in 2010: Repositioning the Value Proposition***. In that document, we offered a simple representation of the then-prevailing factors influencing the strategies for outsourcing and offshoring among leading corporations.

We observed that the economic climate was prompting a foundational focus on near-term cost reduction as a means of enabling strategies related to entering new markets, making more efficient use of investment capital and creating a more responsive capacity to service growth needs. While somewhat traditional in emphasis, we suggested that there existed a decidedly near-term orientation to sourcing strategies and that further reduction in operating costs was considered pivotal to business strategies for the period.

The two most significant points of new emphasis at the time were concerns regarding data privacy and business resilience that carried the potential to disrupt outsourcing adoption. Data privacy was an emerging topic of influence across multiple industries, notably healthcare, financial services and insurance. Resilience, or the ability to respond successfully to threatened disruptions to service availability, was fueled by concerns about global terrorism and natural disasters made acute by the increasingly inter-connected network of service participants for most companies.



Entering 2009, we note several macro-economic issues rising in importance among the strategic decision-makers in major corporations:

- Sales/profits will decrease for many industry sectors
- Spending in many industries will be down
- Unemployment will be up globally
- Resiliency concerns will increase due to terrorism threats
- Government intervention will increase globally

## **OUTSOURCING VS. OFFSHORING**

It's important to delineate between outsourcing as a viable business strategy for enhancing the cost/capability/capacity profile of certain business operations (such as IT, contact center operations, and the like) and the domestic elimination or offshoring of jobs, which can be achieved by outsourcing to a third party or moving work to a wholly owned entity in another country (typically referred to as "captive" centers). These two topics are certainly related, but they are not synonymous.

"**Outsourcing**" functions means that a company has decided to hire a specialist to perform the work processes via a long-term contract, as opposed to delivering the service via internal resources. When a company outsources, it essentially moves responsibility for the performance of a function from an internal organization to an external service provider. While some may emphasize the elimination of jobs from the rolls of the enterprise, this action also creates new jobs among the ranks of the industry service providers and changes the profile of the residual or retained staff. In many cases, new jobs are created to manage the outsourced work. Often, outsourcing enables a company to transform a fixed cost into a variable cost that can be very valuable during times of economic uncertainty. Many service providers have sizable operations within the regions of their larger clients.

Many outsourced functions are delivered via "**offshore**" delivery models. Offshoring utilizes staff located in lower-cost regions of the world. Advances in telecommunications and computing technologies, coupled with the availability of skilled workers and favorable tax considerations, often lead companies to globalize the performance of back-office functions that lend themselves to remote delivery. This tendency increased over recent years as the difference in wages for like-skilled staff, called labor arbitrage, was considerable.

Many companies combine outsourcing and offshoring but many others use offshore resources without going through an outsourcing path. In these cases, companies built their own offshore operations, often called **captives**, to expand the universe of employees that perform functions more cost effectively. In a similar way, many companies contract with service providers to augment existing staff by offshoring via a staff augmentation contract with service providers to gain access to a lower-cost supply of skilled labor.



Not surprisingly, the demand for outsourcing is often accelerated during times of business disruption when corporations are motivated to realign their more supportive human and financial assets that carry a decided back-office orientation. In a recessionary environment, demand typically dips for new outsourcing relationships as organizations become unsure of the future and decide to delay their decision making on long-term contracts. As the economic tide begins to turn, clients set about re-adjusting their costs bases to enable them more flexibility during the bottom of the economic cycle. This is when outsourcing picks up and the increase in outsourcing is a leading indicator of the economic cycle resuming with an upward trajectory.

In other words, outsourcing service providers, while not immune to recession, are among the first businesses to begin to recover from it.

## **OUTSOURCING INDUSTRY PARTICIPANTS**

The prevailing marketplace forces previously outlined introduce differing challenges and motivations for the direct and indirect participants in outsourcing.

### ***Buyer***

- Contraction in the use of India-based service providers in the near term, with a corresponding increase in the use of providers subjected to U.S. securities oversight
- Enhanced focus on rights to transition work between service providers in the event of disaster or lack of compliance with statutory requirements
- Standardization as a means of reducing costs through scale and leveraged solutions fuels the opportunity for industry-based service offerings that may derive from provider acquisition of divested operations of the buyers or joint ventures
- Tendency to more strongly evaluate domestic sources of service, while also shedding employee headcount via outsourcing of those service categories is highly dependent on government actions to subsidize costs via tax policies or other incentives
- Increased use of lower-cost labor via managed services contracting instead of staff augmentation may present a greater opportunity for the U.S.-based service provider that has a considerable offshore footprint
- Transformational changes are needed as a means of securing a better and long-term cost position
- Global operational footprint requires optimization to eliminate any choke points should a disaster lead to an operational shutdown at any global location — add redundant capacity and capabilities at global offshore locations with the ability to transfer flow of work from one center to others across the globe

### ***Providers***

- Coordinated cooperation among India-based providers to restore client confidence in the financial integrity of their operations

- Increased M&A activity — combinations that do not require access to considerable debt — are strong priority to establish sizable footprints in selected vertical industries and related solution offerings
- Acquisition of buyer business operations — both captive offshore centers and domestic back-office operations that may scale
- Data privacy — how will global firms react to protect their business flow?
- Resilience — accelerated interest in country-diversified delivery organizations as a way to increase business resiliency
- Faster bifurcation between commodity and noncommodity areas (as noted in ***The Global Outsourcing Industry in 2010: Repositioning the Value Proposition***)
- Increased reliance upon process transformation to constitute their value proposition
- Competitive necessity will drive providers to provide transactional pricing — moving beyond the recent focus on staff augmentation
- Business Process Management tools are maturing to whereby service providers will seriously look to invest in these tools to transform operations beyond what is expected from the normal process improvement techniques already in play. Pricing per transactions will provide the service providers the ability to recoup their investments.

### **Government**

- Domestic focus (for respective countries) on how to keep the service provider industry growing and keep jobs at home — particularly strong in United States,, India and China via tax and social policy interventions
- Less coordinated government intervention in Europe
- Intervention in India to prevent collapse of Satyam and restore buyer confidence in the regulatory and oversight environment
- Data privacy — will this be used as a lever to drive work back onshore?

### **CATALYSTS FOR CHANGE IN 2009**

In this context, we consider some of the more significant catalysts for change in the global outsourcing industry that are, in themselves, byproducts of the world economic and political climate as we enter 2009.



*Outlook for the Global Outsourcing Industry in 2009*

CATALYSTS	IMPLICATIONS	IMPACTS ON THE GLOBAL OUTSOURCING INDUSTRY
Diminished consumer confidence and spending	<ul style="list-style-type: none"> <li>▪ Declining revenues among consumer-oriented and credit-dependent companies will result in reduction in capacity, including disposal of underutilized assets</li> <li>▪ Government programs will emerge to motivate housing market resurgence and boost consumer spending</li> </ul>	<ul style="list-style-type: none"> <li>▪ Stark reduction in discretionary IT initiatives</li> <li>▪ Private equity owners emerge as “mega buyers” of standardized outsourced services for their portfolios</li> <li>▪ Industry service bureau offerings see increased consideration as way to achieve greater leverage of common systems/processes</li> <li>▪ Contracting conventions oriented around variable cost emerges as a strategy and lessened/trivial fixed-cost commitments as well as using utility-oriented processing and infrastructure offerings</li> <li>▪ Increased use of outsourcing to compensate for decline in employee ranks attributed to cost cutting and to resize the infrastructure of continuing operations.</li> </ul>
Erosion in availability of credit	<ul style="list-style-type: none"> <li>▪ Increasing bankruptcies and liquidations (inability to use debt markets to support mergers)</li> </ul>	
Increased unemployment	<ul style="list-style-type: none"> <li>▪ Emphasize domestic initiatives to remedy infrastructure issues and curtail rising unemployment ranks more thoroughly</li> <li>▪ Focus on domestic employment as a goal of government policy</li> </ul>	<ul style="list-style-type: none"> <li>▪ Slowdown in offshoring of wage-oriented contract positions during times of fiscal distress</li> <li>▪ Restructuring of existing wage-oriented contracts and rebalance the assumption of execution risk</li> <li>▪ Establishment of cost-competitive on-shore trade zones</li> <li>▪ Greater public-private partnership for infrastructure projects and high-priority programs, such as healthcare reform</li> <li>▪ Material government ownership of certain industry entities (for example, banking, automotive) may change policy and practice with regard to procurement and offshoring</li> </ul>
New American administration	<ul style="list-style-type: none"> <li>▪ Establish tax havens for “domestic” outsourcing industry</li> <li>▪ Invest in retraining programs for displaced workers</li> </ul>	
Government investment in certain industries (quasi-nationalization?)	<ul style="list-style-type: none"> <li>▪ Diminish certain “discretionary” programs (for example, space exploration, “green” modernizations)</li> </ul>	



CATALYSTS	IMPLICATIONS	IMPACTS ON THE GLOBAL OUTSOURCING INDUSTRY
Increased threats from global terrorism	<ul style="list-style-type: none"> <li>▪ Less concentrated supply from any one geography/country in order to help ensure business resilience</li> <li>▪ Reduced willingness for U.S. firms to have staff travel internationally</li> <li>▪ Focused sharply on global business resiliency</li> </ul>	<ul style="list-style-type: none"> <li>▪ Increased number of offshore destinations, including greater consideration of China and Latin America</li> <li>▪ Expanded use of third-party services for managing offshore operations oversight to mitigate risk and reduce cost</li> <li>▪ Increased focus on technology solutions related to business continuity and resiliency</li> </ul>

## OUTSOURCING SERVICE PROVIDERS

Service provider companies within the global outsourcing industry are hardly immune to the financial turmoil being experienced globally. Their access to debt is limited, and margins are being compressed by clients unwilling to expand the scope of their agreements or accept customary pricing increases.

The **balance of stability** has changed. Many buy-side firms are in financial distress and their desire to extend credit and payment terms, such as forcing 45- and 60-day payment terms, will be perceived as significant risk by service providers who will likely reflect that risk in their prices, defeating the objective of the buying organization. We see a realignment of business terms to be more equitable. The “buying power” of the many major firms has been compromised by their financial instability, and their procurement organizations will be forced to adjust their approaches to reflect that reality.

In addition, the significance of the Satyam financial irregularities should not be ignored. Clients of the India-based service providers are expressing concern over the viability of these dependencies in the event of financial irregularities or disasters. The Satyam situation has raised the specter of operational risk and remedies to the level of Board Room agendas.

We expect to see **business combinations** driven by the slowed growth in outsourcing demand. We also see mergers being motivated by achieving dominant positions within certain industry segments, allowing for the creation of integrated solutions that may be standardized across clients.

In our opinion, the India-heritage service providers, including Wipro, Infosys, and TCS, are the most likely acquirers. U.S.- and Europe-based service providers such as ACS, CapGemini, CSC, CGI, and Perot will be the most favorable targets. The combination of one of the India market leaders with an established, U.S.-based infrastructure and/or business process outsourcing provider will redefine the competitive landscape. Such combinations will introduce the potential for industry-specific services that may be constructed around cornerstone client operations that are divested during the creation of the merged entities.

The most favorable industries to participate in these combinations include insurance, financial services, healthcare, retail, and consumer durables. In addition, look for India-heritage service providers to begin to **alter their delivery models** by reducing the over reliance on India as a destination. The business need to provide full scope, annuity-like outsourcing solutions will increase. These transactions will necessarily include the takeover of assets and people and establishing delivery capability in the client geographies such as the United States and Europe, apart from the continued expansion of capacity in emerging countries outside India.

Among established service providers, Accenture, HP/EDS, and IBM are, in our opinion, in the best position to weather the storm of changing sourcing strategies during 2009. Whether any of these multinational leaders is receptive to participating in the acquisition of back-office operations from clients to kick-start a service bureau platform remains to be seen.

We anticipate additional change to their service delivery models from an increased focus (on both the buy-side and the provider side) on true process transformation and innovation. As labor arbitrage disappears through natural (wage inflation, skill set and experience increases) and manufactured (government subsidies and tax incentives) factors, value propositions will shift as well. Those providers with significant investments in innovative tools and thought leadership with respect to true process transformation will win the war for talent and the war for clients. This transformation is much more in line with end-to-end value chain improvements than Six Sigma or continuous improvement efforts and thus will prove difficult for some providers to play “catch up” or “follow the leaders.”

The net result is that we envision a **three-way convergence** being likely in 2009 between India-based service, U.S.-based infrastructure capacity, and domain-specific operations derived from corporate divestitures and/or ventures.



## SUMMARY

Given the high rate of unemployment in the United States, a growing trend toward government investment in certain industries and a tendency toward protectionism, expect that outsourcing and/or offshoring activity to be tempered in the short term. However, corporate imperatives to reduce operational costs with minimal or no capital injection, coupled with pressure to enhance productivity and capability, will overcome this initial hesitation, and we expect increased levels of outsourcing activity during the latter half of 2009.

Taken together, we expect to see a **negative impact on pure labor-arbitrage contracting** in 2009 and a slowdown in the establishment of new offshore service relationships. Existing captive offshore operations may be divested or restructured for higher value (distinction between commodity and noncommodity work) as part of broader industry consolidation to create large service bureau capabilities.

Conversely, we expect the initiatives of the incoming Obama administration, coupled with the possible emergence of tax-favorable policies to encourage neutralization of the wage imbalance for certain functions to fuel **increased evaluation of domestic outsourcing**. The same sort of market-stimulus actions may be seen in other regions, notably China and Latin America. The outsourcing industry will lobby hard to seek extension of the tax benefits in India under the, Software Technology Parks of India, or STPI, regime in view of the current market conditions.

Lower-cost destinations such as India, China and Brazil are more likely to employ policies to stimulate more offshoring into their countries.

The United States is likely to employ policies to try to stimulate more domestic and less offshore outsourcing. For the United States and other suffering Western economies, data privacy could become a weapon to force companies to "comply" with locating work in a particular location (because it may be the only "stick" available to counter the "incentives" to move work).

These market changes will fuel **tri-lateral consolidation** among India-based service providers, U.S.- and Europe-based infrastructure providers, and the divested operations of cornerstone client corporations.

Coming out of the recessionary markets in late 2009, we will find a strong global outsourcing industry with four to six large, dominant providers that will provide resiliency to the ecosystem that services the needs of major corporations. Ultimately, that ecosystem will service the needs of middle-market buyers as well.