Global Sourcing Group

Global Sourcing Trends in 2011

By Alistair Maughan (London), Chris Ford (Washington, D.C.), and Nigel Stamp (Hong Kong)

At the beginning of each year, we survey Morrison & Foerster's Global Sourcing Group lawyers in Asia, Europe, and the United States regarding the current state of the world's outsourcing market and emerging trends likely to shape that market over the next twelve months. In this year's update, our lawyers comment on the overall state of the outsourcing market; the rise of Cloud Computing, innovation, and Green IT solutions; and the prospects for outsourcing growth in particular key geographies and economic verticals. We also comment on the key business factors affecting current outsourcing projects and highlight outsourcing-related developments in the key markets across the world.

Our lawyers' views are based on what they have seen in their outsourcing projects during 2010, as well as on the views expressed by service providers, outsourcing consultants, and clients.

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Executive Summary of 2011 Outsourcing Trends

GLOBAL TRENDS

Market Uncertainty	The global economy began its recovery in 2010, but that recovery was less robust than expected. Circumstances such as high unemployment in the U.S. and the near bankruptcy of a number of European countries left outsourcing buyers unsure about the value of entering into long-term outsourcing arrangements. Accordingly, outsourcing in 2010 was flat over the year. Fewer than usual new scope outsourcing deals were transacted and much of the activity involved the restructuring of older deals.
Innovation	Innovation in outsourcing is back on the agenda. As was the case pre-recession, organizations are beginning to expect more from an outsourcing than simply cost-cutting. But the obstacles to the successful achievement of innovation remain the same as they have always been: service provider selection, contracting for innovation, and paying for innovation.
Cloud Computing	Cloud-based solutions continue to grow in importance in the outsourcing market but concerns about data security and data privacy in the Cloud remain high. Customers are now demanding that security be built into cloud services, and the market is driving the emergence of highly secure and trusted cloud services. "Private Clouds" have gained popularity, especially in regulated industries where security and risk concerns may deter companies and their regulators from moving to genuine "public clouds".
Financial Services Regulation	The worlds of outsourcing and financial services regulation will continue to intertwine ever closer. Capital adequacy requirements for banks and insurance companies imposed through Basel II implementation and forthcoming Solvency II and Basel III requirements will change the outsourcing market. If adopted as market practice, these changes may then spread outside the financial services sector. Most immediately, there will be increased emphasis on counterparty risk and the effect on banks' and insurers' capital; and more interest from regulators in outsourcing service providers.
Particular Verticals	Outsourcing by financial institutions bounced back in 2010 in large part because of the restructuring of a number of large IT deals. Activity in the healthcare and pharma industries declined from 2009 levels but remained flat as compared with 2008 activity. These sectors, however, look promising for increased activity in 2011. Travel and transportation outsourcing was up in 2010, to some extent because of the adoption of the outsourcing model by hotel chains. Public sector outsourcing was significantly down in Europe. In the U.S., outsourcing by state and local governments was down as a number of troubled state deals were restructured.
Green IT Issues	Organizations are beginning to do more than merely pay lip service to the implementation of efficient energy and resource use. We are seeing buyers apply energy usage as an evaluation factor in service quality and total cost of ownership calculations; and clients are starting to discuss meaningful service levels around "green" issues. This is an early-stage trend that will increase in 2011, driven by financial reporting requirements, increasing energy costs and, in some countries, statutory requirements.
In praise of… Boredom	While we plead guilty to using our fair share of outsourcing buzzwords—innovation, multisourcing, green, cloud, privacy—we're not so short-sighted that we overlook the only two that really matter: service quality and value for money. Boring but essential.
Globalization	IBM reports that BPO activity in the Philippines exceeded BPO activity in India. This is a sign that outsourcing continues to become more global, migrating to areas where buyers can take advantage of labour arbitrage. Countries like South Africa are making a push into the market by changing laws and granting incentives that will reduce costs for companies seeking to outsource there. Established outsourcing destinations like India are seeking to move up the "sourcing food chain" to retain their piece of the outsourcing market.

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EUROPE

UK Flat; Continental Europe Grows	2010 saw a shift in the pattern of outsourcing across Europe. The UK and German outsourcing markets were flat but there was material growth in several Continental European countries, especially the Nordic region. This market trend is expected to continue for at least the first half of 2011, although Gartner predicts a slight increase in overall spend on IT services in 2011.
Public Sector	National governments across Europe drastically cut spending in 2010. For over half of 2010, the UK public sector outsourcing market—perennially one of Europe's largest outsourcing markets—has effectively been shut down by a UK government moratorium on new projects and a review of every existing project. If the existing controls relax in 2011, there is potential upside in that new services may have to be outsourced to achieve the target deficit reduction, but the risk is that service providers may prioritize sectors where margins are less squeezed.
VAT Changes	In the UK, the rate of VAT on all services, including outsourcing, has gone up to 20% from January 2011, thus increasing the cost of most outsourcing contracts. Offshoring provides no hiding place because the rules were changed in 2010 to levy VAT based on the location of the recipient of services, not the provider. In addition, a longstanding VAT exemption for the insurance sector looks likely to disappear, threatening the business case underpinning outsourcing of many claims handling or insurance intermediary services.

UNITED STATES

Outsourcing Flat in U.S.	According to TPI, outsourcing activity in the U.S. showed modest growth through 3Q10. Growth was a result of restructurings and not new scope deals. Companies seemed to be willing to hire consultants to perform assessments (exhibiting an interest in outsourcing), but were unwilling to move forward with transactions. This seemed to be driven by a lack of confidence in the U.S. economy as forecasts for IT spending during the year were revised to show a spending decrease by companies.
U.S. Mid-Term Elections	Outsourcing took a hit in the U.S. as a result of high unemployment rates. A number of States introduced legislation banning offshoring and companies were hesitant to be associated with any outsourcing activity. This became a major point in the mid-term elections. Although the elections are over, the anti-outsourcing sentiment will not likely abate until unemployment rates in the U.S. recede to historical norms.
Do-It-Yourself Sourcing	In a year when companies continued to tighten their belts to decrease expenses, many outsourcing services buyers who did move forward with transactions chose to do it themselves instead of hiring outsourcing consultants and outside counsel. While this may be practical for companies that have hired sourcing talent, excluding third party professionals can lead to poor results for other buyers.
Legal Process Outsourcing	While legal process outsourcing has been around for nearly a decade, the rate at which it has expanded in 2010 was unprecedented. U.S. companies and even law firms began to adopt LPO as a viable business practice that would reduce expenses. In addition, as the rate of adoption has increased, the kinds of legal work being outsourced have become more sophisticated. It appears that LPO will continue to be a major growth area.

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ASIA	
Continued Growth	2010 has seen continued growth in outsourcing to Asia as the global economy recovers and companies look to further reduce costs in the wake of the global recession by offshoring to lower cost jurisdictions. Offshoring to China has grown further in 2010, boosted by the Chinese government's announcement of generous tax incentives to outsourcing service providers in China's most important cities.
ITO and BPO	Outsourcing to China continues to consist mainly of ITO, with some increase in the outsourcing of other activities such as R&D and even film animation. BPO has seen remarkable growth in 2010, particularly in the Philippines, but also in Malaysia, Thailand and increasingly Vietnam and Indonesia, all of whom are also beginning to enter the ITO market more seriously.
Go West Young Companies	The larger Chinese outsourcing service providers are starting to expand their horizons and look overseas, in particular to the U.S., to raise capital and seek new customers, markets and talent.

GLOBAL TRENDS

Market Uncertainty

"Slow recovery" is the pervasive term that we have heard in 2010 when people speak of the global economy. As unemployment in the U.S. continues to hover around 10% and as a number of European countries ebb and flow on the brink of bankruptcy, economic markets in Europe and the U.S. have yet to attain firm footing following the financial crisis of 2008, resulting in market uncertainty.

We have seen over the last few economic cycles that buyers of outsourcing services do not like economic uncertainty. While, intuitively, it would seem that outsourcing activities would increase during slow economic times, the opposite is in fact true; companies seem to retrench during these periods.

A number of factors may explain this pattern.

- First, outsourcing transactions often carry with them an initial capital investment. Those investments are incurred long before companies realize any cost savings. Accordingly, unless an organization's existing IT or processes are in such a condition that the organization cannot feasibly continue to operate in the then-current environment, organizations are loath to make capital investments in a period where profitability is uncertain.
- Second, administrative costs associated with an outsourcing transaction may make the venture unfeasible in the current environment. The costs include not only those of the outside consultants and lawyers but also the internal costs associated with the time that employees, already overburdened, must give to the matter.
- Third, in an economic environment where organizations are attempting to cut expenses, engaging in an outsourcing transaction may be viewed as a non-essential activity that can be delayed until times are more stable.

The effect of these factors meant that, in 2010, many organizations displayed "sourcing inertia" and were unwilling to move from their current positions. Therefore, we have seen the rate of new scope outsourcings decrease noticeably year-over-year. TPI estimates that, by the end of 3Q10, new scope projects (measured in total contract value) had decreased by 20% from 2009 numbers. But the three "Rs" (Restructurings, Renewals and Re-negotiations) have increased markedly in 2010. This is consistent with the idea that organizations are maintaining a "status quo" mentality.

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Innovation

Innovation in outsourcing is back on the agenda.

For the past two years, all the talk in the outsourcing sector has been about cost

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saving, and all the projects have been about restructuring or re-negotiating outsourcing contracts in order to deliver value for money (which really means lower costs). That is changing: organizations are beginning to expect more from an outsourcing than simply cost-cutting.

A recent study from the U.S. about companies seeking innovation in business processing outsourcing shows that 43% of executives in outsourcing customers view innovation as a critical element of BPO. It's also true to say that cost-cutting and re-negotiation of the cost baseline of an outsourcing project can only save cost once: successful innovation can create a multiplier effect which can lead to increased savings going forward. So it makes sense that executives still see innovation as something that is important in their outsourcing relationship.

But outsourcing very rarely leads to innovation unless it's either the central purpose of a project or the subject of a specific targeted governance mechanism. The lower down the list of priorities innovation sits, the less likely it is actually to appear. A lowest cost mentality will never deliver innovation.

Over the next 12 months, companies will again grapple with issues around service provider selection, contracting for innovation, and paying for innovation. Ultimately, innovation is not something that can be measured like a service level, i.e., read off a spreadsheet. It needs to be handled sensitively and in a collaborative manner if it's going to happen at all.

Cloud Computing

Cloud-based solutions will continue to grow in importance in the outsourcing market. What makes Cloud a delivery mechanism that's here to stay (unlike its predecessors utility computing, ASP, grid computing) is the perfect combination of (a) flexible delivery model with multiple sources, (b) cheap price at a time of recession, and (c) maximizing remote capacity at a time when fast internet access to such capacity is now highly reliable. Not all of those three factors were present in prior iterations of so-called "fully-flexible IT delivery" models.

Concerns about data security and data privacy in the Cloud remain high. They are currently the main reasons that organizations cite for not moving to a cloud model. Infrastructure providers and platform providers are focussed on this fact and are working to develop stronger security capabilities. In the next two years, the development of cloud security solutions will grow into a significant market of its own, as all providers look to turn data security from an inhibitor to an enabler of cloud computing. One issue is whether the traditional service providers will fill this space or whether a new breed of niche cloud security providers will react faster.

Customers are now demanding that security be built into cloud services, and the market is driving the emergence of highly secure and trusted cloud services. The traditional ICT market dwarfs the IT security market by a factor of 30:1. That ratio will narrow as security becomes a more vital part of IT operations moving to the Cloud.

For larger customers, "Private Clouds" will continue to be implemented as the benefits of virtualization are realized without the risks associated with operating in a shared environment. Nonetheless, such customers will put a "toe in the water" for applications that are less sensitive to the risks associated with privacy breaches. Eventually, most such customers will adopt a "hybrid" solution where a public or private solution will be provisioned depending on the risk profile of the data processed by the application. As public cloud solutions are created, and standards are recognized for verification of privacy and data security compliance, some of the private solutions will migrate to the public cloud. This will take a few years.

Most industries stand to benefit from adopting cloud solutions, but until compliant solutions are created and verified, only those with little or no personal data are likely to benefit. The trailing adopters will be (a) data-heavy sectors where the barriers to cross-border data transfer are high; and (b) regulated industries (e.g., financial services and pharma). This is because regulators—especially financial services regulators such as the UK Financial Services Authority—will be slow to produce regulations that guide regulated entities as to how they should use cloud solutions. This will inhibit the adoption of public Cloud solutions by banks and insurance companies.

Security and latency will continue to be important issues for trading banks (see discussion below under Financial Services Regulation).

Financial Services Regulation

Capital adequacy requirements imposed and to be imposed on banks and insurance companies on a global basis through Basel II implementation and forthcoming Solvency II and Basel III requirements will change the outsourcing market. If adopted as market practice, these changes may then spread outside the financial services sector. Most immediately, there will be increased emphasis on counterparty risk and the effect on banks' and insurers' capital; and more interest from regulators in outsourcing service providers.

This will mean that banks and insurance companies may prefer to concentrate on larger outsourcers who are more creditworthy. Banks will insist that outsourcing service providers take on

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more risk for system failures that affect the bank—a situation that may change the way in which contracts (especially liability provisions) are negotiated. In an interesting recent case in Singapore, IBM was required by the regulator to publish the cause of a system problem and the bank, DBS, had to put up more operational risk capital until the regulator was satisfied that IBM had remedied its system weaknesses.

Security and latency will be key issues for trading banks. This could make cloud computing more challenging in the financial services sector. Any slight slowdown in the ability to carry out hundreds of transactions per second caused by system or network issues will affect a bank's risk profile with the regulators. So, for core parts of their operations, banks may not be able to consider a public cloud, and even private clouds may not have good enough latency. Instead, banks will look for dedicated IT services from outsourcers or else perform this task in-house.

Increased focus on regulatory capital will push up cost for some ITOs. Service providers will be judged as much on security, performance and taking/sharing some or the bank's risk capital and not just on the unit price of the service.

There could be a change in the recent trend towards multi-sourcing. In order to reduce outsourcing risk, banks may prefer to have fewer trusted partners who can step up and perform rather than rely on multiple suppliers.

ORGANIZATIONS ARE BEGINNING TO DO MORE THAN MERELY PAY LIP SERVICE TO THE IMPLEMENTATION OF EFFICIENT ENERGY AND RESOURCE USE.

Particular Verticals

Financial Services

In an overall downbeat outsourcing market, few industry segments showed significant growth in 2010. According to TPI, outsourcing in the financial services industry (which includes insurance companies) made a significant comeback in 2010. They claim this was due, in large part, to a number of large restructurings in the sector. We note, however, that middle market financial institutions have begun to adopt outsourcing as a model in greater numbers than in years past.

Travel and Transportation

Activity in the travel, transportation and hospitality industry seemed to have increased over the last year. We believe that this was due in large part to a number of hotel chains outsourcing their IT. Hotels have historically been slow adopters of outsourcing, and therefore 2010's activity showed a major shift in thinking in that industry.

Healthcare

Although TPI's report showed that the healthcare and pharma industry declined year-over-year in 2010 but was consistent with activity in 2008, these companies seemed to generate significant activity in 2010. It may be that these companies were generating more deals with smaller TCV, and this development would account for the decline since TPI's measure was in TCV. Nonetheless, industry professionals expect that healthcare and pharma will be strong in the near future as these companies struggle to comply with the U.S. Healthcare legislation passed in 2009.

Government

As stated below, governments in Europe drastically cut IT spending in 2010. Federal Government in the U.S. seemed to continue apace in 2010. A number of large-scale federal government deals were re-negotiated in 2010, and it seemed that CSC was involved in many of them. New activity with respect to state and local transactions was sparse, at best. Many of the states that had previously outsourced were in the process of working out deals that had gotten off track (e.g., Texas, Virginia and Indiana).

One thing to note, however, was the transaction completed last year between CSC and the City of Los Angeles. This was a Cloud Computing transaction that could potentially be a roadmap for future state and local transactions.

Green IT Issues

Organizations are beginning to do more than merely pay lip service to the implementation of efficient energy and resource use. This is an early stage trend but one that will increase in 2011, driven by financial reporting requirements, increasing energy costs and, in some countries, statutory requirements.

For the past 3 years, organizations have prioritized short-term cost cutting over longer-term strategies in setting outsourcing directions. This is changing and, as it does so, the issue of "Green IT" is coming back on to the agenda. Most organizations nowadays have an environmental or sustainability policy. Very often, those policies are merely "green-wash" that get overlooked, or the policies don't go deep enough into the organization's operations and, especially, into its supply chain.

IT operations are major consumers of energy and producers of carbon. It's a surprising statistic that the IT sector produces about 2% of global CO2 emissions, which is about as much as the airline industry. Energy cost is becoming a more significant issue and a bigger part of technology budgets. In 2007, Gartner estimated that large corporations spent between 4% and 8% of their ICT budget on energy and that, by 2011, this figure will have increased to 32%. Data centers

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THE ONLY TWO BUZZWORDS THAT REALLY MATTER: SERVICE QUALITY AND VALUE FOR MONEY. BORING BUT ESSENTIAL.

in particular are huge power consumers: Gartner estimates that a third of the energy used by data centres is now used on cooling servers.

While the United States has not yet ratified the Kyoto Protocol on climate change, many other countries have not only done so but have also taken steps to introduce national legislation requiring organizations to take specific steps designed to reduce emissions and reward energy efficient businesses. Most EU countries have done so—and the UK has gone a step further and implemented the CRC Energy Efficiency Scheme, a mandatory energy efficiency and emissions trading scheme. The CRC requires large energy users in the UK to comply with a cap-and-trade scheme of energy allowances.

We are seeing outsourcing buyers react positively to the "pull" of cost reduction and corporate social responsibility initiatives and the "push" of national laws. Companies are starting to apply energy usage as an evaluation factor in assessing service quality and calculating total cost of ownership. More organizations are considering the next steps beyond merely referencing general sustainability policies, and clients are starting to discuss meaningful service levels around "green" issues and incorporation of specific sustainability, energy usage and waste reduction requirements as part of service schedules.

In Praise Of… Boredom

OK, OK. We know that we've used our fair share of outsourcing buzzwords—innovation, multisourcing, green, cloud, privacy. But we're not so short-sighted that we overlook the only two that really matter: service quality and value for money. Boring but essential.

Outsourcing in 2010 suffered the recession backlash as buyers put projects on hold, re-negotiated existing projects and then worked out where to spend their remaining budgets. Industry commentators and, especially, service providers fell over themselves to predict the features that would define the future outsourcing market and the characteristics of the most successful service providers in 2011.

But, in the rush, too many people overlooked the basics. Companies may have short-term memories but they still haven't forgotten the cost impact of the wave of over-reaching outsourcing projects created during 2004 – 2007. Innovation, green, private cloud solutions are moving up buyers' agendas, as we've said, but we can't forget the good old-fashioned boring stuff like providing a solid reliable solution at a fair price.

The main distinguishing feature that the majority of CEOs will continue to look for in 2011 is a service provider that can consistently deliver good quality services with minimal downtime and a fair and predictable price. A service provider's best route to outsourcing success will always be to capitalise on a client relationship established with a solid foundation in order to expand its footprint within a buyer and potentially sell on higher margin services.

The essential underpinning requirement for a fair price cuts both ways, of course. Many outsourcing buyers have spent 2010 squeezing the pips out of service providers. The gamble is that service providers will still value their customer even with reduced margins. The danger is that key service providers start to prioritize their best resources elsewhere on to higher margin customers. If they do so, the frenzy by some customers in 2010 to force reduced prices may backfire on them.

Globalization Continues to Dominate the BPO Industry

While organizations that outsource may be looking again at things like innovation and improved service delivery as reasons to outsource, outsourcing as a means to achieve cost savings has never changed from being the overarching factor or criterion that companies choose to outsource. India was the first country to take advantage of the globalization trend by changing laws and offering tax incentives to attract mainly U.S. businesses to outsource there. That tactic was a huge success, making India the go-to offshore destination for U.S. and European companies for outsourcing, and birthing more than a few Indian-heritage service providers. The success of the industry in India was based upon labour arbitrage—i.e., outsourcing to a place with an educated workforce where labor was cheaper so that companies could obtain equal value for a lower price.

While India continues to be a very significant destination for offshore outsourcing, and Indian-heritage service providers continue to do well and in fact have been steadily taking market share from U.S. based service providers over the past decade, over the last several years India has begun to be challenged as the undisputed destination. Other countries with an educated population who have large numbers of English speakers and who are able to offer even cheaper prices than India because of lower labor rates have seen an influx in sourcing activity. Recently IBM reported that the Philippines has overtaken India as the number one country for shared services and business process outsourcing.

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And the Philippines is not the only country that is getting into the game. South Africa, for example, has cited BPO as its key growth industry in the coming years. In November 2010, South Africa announced that it would offer tax reimbursements to the tune of about 120,000 rand for a period of three years for each job created by the BPO firms in the country. It is estimated that these incentives will lower the operation costs by nearly 20% when 10 to 400 jobs are created, and 30% when in excess of 800 of jobs are created. The ability of South African firms to lower operational costs will significantly reduce their cost of delivering services and allow those firms to attract more U.S. and European-based business because of their cost-competitiveness.

India, on the other hand, recognizes that it must move up the food chain to retain its market position in BPO. Thus, as has been the trend over the last several years, firms in India are broadening their offerings into more highly skilled services such as legal process outsourcing. ■

EUROPE

UK Flat; Continental Europe Grows

2010 saw a shift in the pattern of outsourcing across Europe. In particular, the UK and German outsourcing markets were flat but there was material growth in several Continental European countries, especially the Nordic region. This market trend is expected to continue for at least the first half of 2011, although Gartner predicts a slight increase in overall spend on IT services in 2011.

Outsourcing consultancy TPI examined the number of new outsourcing contracts signed by European businesses. In Q3 of 2010, the total value of contracts was €5bn, which is 8% lower than the previous quarter and 10% lower than the same period a year before.

TPI also reports that spending on outsourcing increased in Scandinavia as a result of several large-scale restructuring deals signed in the first nine months of 2010. However, in the traditionally largest EMEA markets, the UK and Germany, the total value of new contracts awarded fell dramatically. In the UK, this is largely attributable to the temporary suspension of the public sector market (see next section).

Our experience of the EMEA market is that, while the recession may be over, outsourcing customers are still nervous and reluctant to invest in new large projects. Companies based in markets such as Scandinavia and the Netherlands, which are growing faster than some of the larger economies in Europe, are more prepared to begin new outsourcing services. In some cases, the first-time adoption of multisourcing is fuelling growth.

Public Sector

National governments across Europe drastically cut spending in 2010. This trend will continue to affect the EMEA market in 2011.

For many years, the biggest single market for outsourcing in Europe has been the UK public sector. Successive UK governments have adopted an approach of outsourcing significant chunks of public services, both back office support (some of the largest IT deals in Europe have been UK public sector ITOs) and front-line services (e.g., the provision of prisons, hospitals, bridges by the private sector).

That market ground to a halt in dramatic fashion earlier this year in the run up to the UK general election in May 2010. By tradition, once an election is announced in the UK, no significant new administrative projects are commenced pending the election outcome and possible changes in policy direction.

As it transpired, the election resulted in a coalition government, one of whose first tasks was to announce an across-the-board moratorium on any new outsourcing project and a review on every existing public sector ICT and outsourcing project. That review effectively shut down the central government outsourcing market in a single stroke.

A number of large outsourcing projects were scrapped entirely—most notably the NHS “Connecting for Health” project, a £12.7 billion giant, and the controversial ID cards project.

The coalition government’s next task was to call in the top 19 ICT service providers to central government and negotiate agreements with each of them as to how they would reduce the costs of their existing and future outsourcing projects. Many of those negotiations were acrimonious with a number of service providers feeling that the UK government was adopting very heavy-handed bullying tactics in order to push through margin reductions.

The result of the moratorium and a relaxation of the ban on new projects are still awaited. Consequently, a significant sector of the European outsourcing market has effectively been shut down for most of 2010.

In theory, this market should bounce back in 2011 because one of the less well publicized aspects of the UK Government policy is that the public sector deficit in the UK can be cut by the application of increased outsourcing for services that are still provided internally within Government. However, only time will tell when, if ever, this market will recover to pre-2010 levels.

One risk for the UK public sector is that key service providers may not have the patience to wait for the market to recover and, if margins are being squeezed, may prioritize their best resources on other more profitable outsourcing sectors, such as the recovering financial services sector.

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UK local government outsourcing remains buoyant—even in growth mode, as local councils explored shared services and the use of outsourcing to cope with the expected budget cuts in funding—although local government outsourcing has in the past been a fragmented market of smaller deals, generally considered too small to "shift the dial" in measures of industry health.

VAT Changes

The outsourcing industry could be forgiven for believing that the EU tax authorities bear a grudge against it.

2010 started with the implementation of a new EU "place of supply" rule that required VAT to be charged on transactions (including outsourcing) based on the location of the recipient of services as opposed to the home country of the provider of services. As a result, a whole range of offshore services, including offshore outsourcing services, became subject to VAT. Organizations that previously offshored to jurisdictions without VAT found that, unless another exemption could be identified, the cost of the outsourcing contracts rose by a material amount as a result of VAT that had to be added to the charges left by the service provider.

In the UK, the VAT rate goes up to 20% on 4 January 2011, adding another 2.5% to the cost of outsourcing contracts.

And there was more VAT bad news for insurance industry outsourcers in late 2010. The EMEA insurance sector has benefitted over the years from a VAT exemption on outsourced claims handling and other outsourced insurance-related services. This was considered to be particularly important by the insurance industry because, to a large extent, insurance companies do not bear "output VAT" on which the tax on their outsourcing transactions can be offset. VAT levied on insurance outsourcing projects therefore becomes a direct hit on the bottom line.

The outsourcing industry in the insurance sector has stretched the scope of the original exemption and for some years the EU has targeted the insurance industry to try to simplify the position. As a result of an announcement by the UK Treasury in October 2010, the insurance industry may lose that concession as part of a push to undertake a simplification of Europe-wide insurance VAT rules. It seems that the UK Treasury has now conceded that maintaining this exemption for the insurance industry is unlikely to be possible in the long term and there may have to be a sacrifice of the exemption from insurance outsourcing as a trade-off for exemption of other financial services outsourcing and intermediary activities.

Combined with the increase in the VAT rate in the UK (where many insurance companies are based) to 20% in January 2011 in the UK, this could mean a significant increase in outsourcing costs for a significant sector of the outsourcing industry. ■

UNITED STATES

U.S. Markets Continue to be Flat

A sluggish economic recovery in the U.S. has resulted in sluggish outsourcing activity in the U.S. in 2010. Although TPI reports that total contract value has increased in the U.S. by 17% through 3Q10; such growth has been fueled by companies restructuring long and medium term sourcing deals, as opposed to growth brought about by new scope. Accordingly, the overall market for outsourcing deals (in terms of the number of companies engaged in outsourcing) has not grown in 2010.

Based upon our discussions with industry professionals, it appears that companies have continued to "kick the tires" about outsourcing ventures but are not ready to buy the car. In other words, companies that are considering new scope projects have retained advisors to conduct sourcing assessments, but relatively few have moved forward with a sourcing transaction.

OUTSOURCING CONSULTANTS HAVE REPORTED THAT THERE HAS BEEN SIGNIFICANT ASSESSMENT ACTIVITY.

This slowness should not be surprising given the trends in IT spending. Early in 2010, Forrester Research estimated that U.S. IT spend would grow 9.9% in 2010. Forrester revised that forecast in August, citing that macroeconomic conditions have slowed growth and interest in investment. For the last several economic cycles, outsourcing and IT investment have lagged behind the economic recovery, and that seems to be the case in this recovery as well.

The good news is that the outsourcing consultants have reported that there has been significant assessment activity, which leads to the conclusion that there is likely latent demand for sourcing transactions. This portends well for outsourcing if macroeconomic conditions continue on an upward trajectory.

Mid-Term Elections and Unemployment

The mid-term elections in the U.S. may have had an impact in the slow down of outsourcing activity in the U.S. High unemployment rates seemed to overtake the news for many months leading up to the election. Outsourcing became an unpopular word as it was equated with moving U.S. jobs to offshore locations. Organizations in the U.S. did not want to be associated with such activity; so even those who engaged in outsourcing were

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cautious about that information becoming public. This trend was accentuated by a number of states (e.g., Ohio) introducing anti-offshoring legislation.

Although the mid-term elections are over, and the political party that has historically supported outsourcing has regained significant political power in Washington, outsourcing may continue to be a dirty word until the unemployment rate in the U.S. declines—which most forecast will remain above 9% until mid 2011 and will exceed 9% through all of 2011.

It is not clear whether this means that organizations will continue to delay their sourcing activities until the unemployment rate dips, but it is clear that such organizations will take unemployment into account when making a sourcing decision. The impact may not be a result of an altruistic effort to keep U.S. jobs onshore, but may be a function of preserving a public image in an environment that is hyper-sensitive about losing jobs.

Do-It-Yourself Sourcing

In our trends article last year, we noted that a number of companies who were involved in outsourcing transactions were attempting these transactions without the assistance of third-party consultants or outside counsel. We noted that this was likely the case where those companies felt a need to outsource, but, as a result of pressures (resulting mainly from the financial crisis and economic downturn), they were opting to do it without the assistance of third parties. This trend continued in 2010. In fact we note that a number of large deals (in excess of $500 million in total contract value) were done in this manner. We acknowledge that companies that are in their third or fourth generation and that have set up sourcing organizations with experienced individuals may not need the help of third parties. However, for companies that do not fall within that category, the do-it-yourself method can be treacherous.

Much of the value added by third parties stems from (1) an understanding of what is normal in the market, (2) familiarity with the service providers and (3) a historical view of outcomes from former transactions. In addition to bringing order to an often chaotic environment, the three value adds will help to provide a framework that will protect the interests of outsourcing buyers long term. Without an understanding of the market norms, what the interests of the providers are and what bad things may happen, buyers are often left to the devices of the providers. Because providers engage in these transactions every day, it is an uneven match—heavily weighted in the favour of the provider. Third parties help to even the match (and in most cases tip the scales in favour of the buyer).

Third-party advisors, however, must understand the pressures that the buyers are under and find ways to provide their services in a more economical way, and in a way that will get the outsourcing deal to completion more quickly.

Legal Process Outsourcing

While legal process outsourcing, or LPO, has been around for some time, the last two years have witnessed a dramatic expansion in its embrace by corporate law departments and by large US law firms seeking to address recessionary pressures.

While work performed by LPO firms historically consisted of basic tasks such as contract review, contract management and transaction support services, available services are multiplying and moving up the food chain of legal services to include substantive patent work, legal research and contract preparation. As a sign of a robust LPO market, financial and strategic buyers have been acquiring stakes in LPO firms. In February 2010, Intermediate Capital Group acquired an interest in CPG Global, a leading LPO firm founded in the UK in 1969 originally to manage patent renewals. In November 2010, Thomson Reuters acquired Pangea3, a leading LPO provider headquartered in New York and Mumbai.

Predictions of the growth of LPO vary by source, but there appears to be consensus that growth will be robust in 2011. Our experience is that corporate law departments and law firms alike are coming to view LPO as a means of reducing expenses in areas where offshoring is not viewed as presenting unmanageable risks. We expect the trend to continue. ■

ASIA

Continued Growth

2010 has seen continued growth in outsourcing to Asia as the global economy recovers, and U.S., European and Japanese multinationals look to reduce costs in the wake of the global recession by offshoring to lower cost jurisdictions.

Offshoring to China has grown further in 2010 and, with the Chinese government's announcement of generous tax incentives to outsourcing service providers in 21 major Chinese cities that run through to 2013, this trend will accelerate through 2011 and beyond, keeping China on track to pose a serious threat to India's

THE CHINESE GOVERNMENT'S ANNOUNCEMENT OF GENEROUS TAX INCENTIVES TO OUTSOURCING SERVICE PROVIDERS IN 21 MAJOR CHINESE CITIES

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dominance in the longer term, particularly in ITO.

From 1 July 2010, outsourcing companies located in the 21 most important cities of China (in the eyes of the Chinese Government) that are engaged in offshore service outsourcing are eligible for business tax exemption through 31 December 2013. The 5% operating tax exemption is the latest attempt by the central government to promote outsourcing and to try to end India's dominance of the offshore ITO sector. Two and a half year's holiday is a big tax concession and will no doubt increase the rate of acceleration in the growth of China's share of the market over this period. Hangzhou, a major city in China, was in the middle of a large scale advertising campaign at the time promoting it as the "Financial Outsourcing Zone" of China, and this type of assistance from the government can only be a huge boost to this initiative.

ITO and BPO

Outsourcing to China continues to consist mainly of ITO, and still mostly applications development and maintenance, but there has been a noticeable trend to larger, longer term projects than previously. We see the outsourcing of more business critical applications, in some cases with limited access to production data, rather than the "toe in the water" approach that was prevalent before the global recession.

There are still lingering concerns regarding data security, confidentiality and the protection of intellectual property, but customers appear to be getting more comfortable with the perceived level of risk, provided it is as well managed as possible, in exchange for the financial benefits.

In addition to the more mainstream ITO, we have also seen an increase in the outsourcing of other activities to China in 2010 such as R&D and even areas such as film animation. Financial institutions have led the charge in the main in terms of customers but others such as media companies are also beginning to see the advantages of outsourcing to China as well.

BPO has seen marked growth in Asia in 2010, particularly in the Philippines. Numerous service providers in the Philippines opened new centers during the year, and many also stated their intention to significantly increase their workforce during 2011. Rainmaker Systems, Inc., for example, opened one new major center in 2010 and stated that it planned to double its workforce over the next 12 months, and it was not alone. Malaysia, Thailand and increasingly Vietnam and Indonesia also offer an increasingly significant number of BPO service providers and they are all likely to take a larger share of the BPO market in 2011 and beyond. These latter countries are also increasingly offering ITO services as well and are likely to take an increasing share of that market in 2011 in addition to China.

Go West Young Companies

The largest Chinese providers of outsourcing services are starting to expand their horizons and look overseas, in particular to the U.S., to raise capital and seek new customers, markets and talent.

Near the end of the year, Beijing-based iSoftStone Holdings, Inc., which has 10,000 employees, mainly in China, but an increasing number of whom are now U.S. educated Chinese returnees, listed on the New York Stock Exchange, raising just over US$140 million. Earlier in the year it also acquired Ascend, a U.S.-based IT consulting firm with Fortune 1000 clients. iSoftstone is looking for U.S. clients, in particular global banks and other financial institutions, and believes that these actions will help it get them. Listings such as this also help these companies hire better talent, which in turn also serves the same purpose: acquiring new clients.

Mid year, HiSoft International, based in Dalian, in China's northeast, was also listed on the NASDAQ. It claimed to be the first Chinese IT and BPO outsourcing company to complete an IPO.

2011 will undoubtedly see more such activity. ■