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Outsourcing and the Economic Crisis, Part IV: Crunch Sourcing - The New Economics of the Outsourcing Market

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The world is now deep enough into the current recession that it's possible to draw some clear conclusions as to how the global outsourcing market is being affected. Instead of relying on predictions and forecasts, we have hard data-points and practical experience that point the way as to how the remainder of 2009 might be impacted.

What do the signposts show? Certainly, an outsourcing world that's different from that of the past few years, with some parts of the market faring much better than others. Outsourcing may not have been the recession-busting marvel that many industry experts predicted; but outsourcing customers (and even some outsourcing service providers) are in better position to come out of the recession than they might have expected.

Outsourcing and the Global Recession

Over the past 12 months, many industry experts have predicted potentially significant outsourcing growth despite the global recession. The theory has been that outsourcing ought to be counter-cyclical as companies look to use outsourcing as a way to cut costs in the short term by reducing head-count, and moving assets and liabilities from their balance sheets on to those of their service providers.

In fact, the story over the past 12 months has been one of steady, but not spectacular, growth. The International Association of Outsourcing Professionals, a leading industry association, conducted a survey of their members and found that:

- 75% of organizations planned to continue with their outsourcing plans, or to increase outsourcing in response to the recession;
- 19% of organizations have re-negotiated the prices and terms of their existing outsourcing contracts; and
- 25% of organizations report lower volumes on their existing contracts.

But if you look beneath the surface of the published surveys, the market has reacted differently than expected. Year-on-year, 2009 has started much slower for the outsourcing industry than 2008. Leading market analyst TPI has reported that the trend is due to extreme increased activity and a surge in the number of contracts (especially in Europe) in the six months spanning the end of 2007 and the beginning of 2008. So, while the volume of deals in 2009 so far has dipped since 2008, this ought to be seen as merely a return to normal levels of activity from a peak in early 2008. In all likelihood, 2009 will resemble the second half of 2008, not the first half.

Most service providers to whom we speak have good pipelines of activity, although they report that new projects are taking much longer to initiate. As companies' liquidity has decreased, they are engaging in longer evaluation and investment decision cycles, resulting in projects taking longer to come to fruition.

In general, the outsourcing market is holding its position. Recessions typically lead companies to use controlled growth in managed services because they do not have the appropriate internal resources themselves. Additionally, the procurement of external managed services provides companies with financial safeguards against unnecessary investment in rapidly evolving new technologies with short, useful lives.

The focus of outsourcing activity at the moment seems to be on quality, flexibility, and saving. Interestingly, in the same IAOP survey cited above, more companies have identified their key goal as attaining greater contract flexibility from their outsourcing relationships rather than simply achieving greater up-front or overall savings.

This perhaps reflects the greater maturity of many outsourcing buyers since the last recession. Previously, deals were often done in haste to secure short-term cost savings. Such deals often became millstones around the buyer's neck once the economy improved – the short term, one-time financial gains were at many times trade-offs for longer term service inefficiencies.

Changes in Deal Shapes

Overall, the real story of outsourcing at the moment seems to be the continued emphasis on small deals and, in particular, companies focusing on "housekeeping" *i.e.*, cleaning up their managed services relationships; restructuring; realignment; and renewal. In the United States, certain governmental entities continue to do large transformational outsourcing transactions; for example, one of the authors of this article recently represented the State of Georgia in its transformational IT outsourcing to both AT&T and IBM. But the general picture is that, currently, very few large private sector transformational deals are being done: TPI reports that in the second half of 2008 there were only three outsourcing deals done with a contract value of more than $1 billion (compared to 12 in the first half of 2008).

The reason for the underlying trend in favor of smaller deals is that companies are focusing more on tactical initiatives designed to achieve specific goals, rather than larger, "bet the company" projects. This also tends to deliver a different type of deal. Deal structures are changing in the following ways:

- deals driven by cost savings look different from those done in better economic times by emphasizing reduction in head-count and de-emphasizing savings from a reduction in capital investments;
- tightening of credit means that the structuring of deals for the purposes of financial "packaging" is much more difficult, and accordingly less common. Deals which, in the past, may have been structured around a "buy now, pay later" charging model are now less capable of external financing;
- deal terms are getting shorter to allow both customers and service providers to restructure more frequently to account for shifting market conditions;
- there is an emphasis on the already well-established underlying trend towards multi-sourcing;
- there is an openness to alternative service delivery models (and hence the rise of cloud computing as a popular topic); and
- overall, there is an insistence from outsourcing clients that service providers should "do more with less".

Service Providers and the Recession

The recession is not overturning the natural order of things in the service provider marketplace.

The Tier 1 vendors have proven to be perennially strong and to be in the best position to survive the recession with their market share intact or even enhanced. The India-origin vendors continue to succeed, although their margins are not holding up to the previously high levels of prior years. Of greater concern is the position and market share of the mid-sized or middle market vendors who might get squeezed between the Tier 1 vendors and the India-origin vendors.

It remains the case that service providers who do well are those with sectoral and geographic diversity, well-managed overheads, and deep, long-term customer relationships. In addition, service providers need to be able to cope well with the new deal shapes discussed above.

Service providers are also in an unusual position of having to perform more robust due diligence on their customers' ability to pay – which often hasn't been the case in the past. In addition, most service providers have undertaken some downsizing to reduce redundancy in order to make certain that their cost bases are best positioned to survive the recession.

In additional to these general factors, two key features of the vendor marketplace over the past 12 months have been the acquisition of EDS by HP and the Satyam scandal in India.

The combination of HP and EDS has quietly resulted in greater efficiencies and is showing signs of success in terms of new deal wins. It is fair to say that, even prior to the HP acquisition, the vestiges of EDS's financial woes of 2003 through 2006 were waning. However, with the combination, EDS is re-emerging as a dominant player in the outsourcing marketplace.

The Satyam scandal that caused such turbulence a number of months ago has proven to be isolated. Tech Mahindra has bought a controlling stake in Satyam. The fact that this move has been concluded (relatively) quickly is good news for Satyam's customers. The Indian government and the offshore and outsourcing industry in general (spearheaded by NASSCOM, a key trade association in India) have operated effectively to make certain that the sell-off of Satyam does not become a protracted experience. The hope of the Indian government must be that the sell-off brings to an end public concern about the Satyam scandal.

It is interesting to recall that the original fear at the time the Satyam scandal broke was that this might be a systemic problem to all Indian outsourcers. That issue has receded, and so the main concern of those supporting the Indian outsourcing industry had likewise ebbed. However, the problem remained of what to do with Satyam itself. But, of course, Satyam had a significant infrastructure and some great customers, so it is not surprising that there was considerable interest in acquiring the business. The key task was to segregate the corporate-level fraudulent accounting from Satyam's service delivery. It seems that such segregation has been successful and has helped to reassure customers.

Of course, the task of Tech Mahindra as it completes the acquisition of the controlling stake in Satyam will be to assure Satyam's customers that there will be no loss of quality. Many of the other service providers, including the large Tier 1 service providers, have been circling around Satyam's customers for some time and have set up "hit squads" of their professionals aimed at luring away Satyam's customers during this period of uncertainty. The hope of Tech Mahindra is that the period of months between the time of the scandal breaking and the time of the acquisition has not been sufficiently long to erode the client loyalty that Satyam had built up with its customers.

Differences in Global Markets

The outsourcing marketplace at the moment is a tale of three regions. The U.S. outsourcing market seems to be holding up well and TPI recently reported that the outsourcing market in the U.S. had its best quarter since 2007, bolstered in particular by the success of IT outsourcing.

The EMEA market has been less successful than the U.S. outsourcing market. The UK market has been relatively weak and the Continental European market is still under-penetrated. The business process outsourcing market in Europe is still much smaller than the IT outsourcing market.

Asia remains a small market by comparison. Japan has still not really taken up the outsourcing trend and so, overall, the Asia Pacific outsourcing market displays less maturity and more volatility. Asia remains largely a services marketplace. India continues to do well, especially in infrastructure and applications outsourcing. China continues to succeed partly as a secondary market and partly in relation to applications development and technical outsourcing.

The worry for the outsourcing industry must be partly that the BPO market is not holding up as well as the ITO market. Again, the reason for this is the near-term tactical focus that clients have at the moment: there is a realization that BPO tends to be a strategic decision involving a transformational journey and most companies do not currently have the time to wait (nor free cash to invest) to achieve savings that BPO might deliver. Their key focus is more a short-term realization of savings and efficiencies – and ITO holds the bigger offering there.

Do More with Less

While many outsourcing customers are reluctant to commit to new outsourcing projects at the moment, a very large proportion of them are closely studying their existing relationships to determine how more value can be derived from them. This typically means deriving further value and cost improvement via a re-negotiation of pricing, service levels, and other key terms. We have seen companies seeking to reduce service level requirements to reduce the cost of service delivery and therefore charges; remove all necessary scope; delay planned transformations; and re-visit technology refresh cycles. We also see companies looking more aggressively at enforcing their contractual rights; for example, to service credits, to the exercise of benchmarking, or to the implementation of audit rights.

Unfortunately, many companies are finding that the skills necessary to run a successful re-negotiation or re-alignment project are different from those needed to do the initial procurement. They need to focus more resources on the initial assessment of what the value opportunity is. Many companies run headlong into a re-negotiation without taking the time to consider exactly what the opportunity might be and where the savings might lie. Equally, many customers assume that it is their right and privilege to re-negotiate downwards without considering the service provider's motivation or how the service provider can be persuaded to contribute positively to the re-negotiation exercise. Appropriate governance and appropriate senior-level accountability are key factors in this exercise.

Companies are finding that they need to understand much better where the hidden value might be and what is of real importance to them in the delivery of their outsourcing goals. In many cases, there are significant easy wins to be had in terms of re-considering features of their outsourcing relationships that may have made sense in good times but that become potentially expensive luxuries during a recession.

Customers must be strategic in their methods of causing service providers to engage in re-negotiations. Instead of using the "stick" method to force service providers to focus on what is important to the buyers, customers should utilize the "carrot" method to allow both parties to benefit from the re-negotiation exercise (*i.e.*, by allowing the service provider itself to realize appropriate savings). Otherwise, it may be difficult to engage in negotiations that meet the customer's requirements.

Conclusion

While outsourcing activity has continued to grow slightly during the recession, the boom of outsourcing transactions expected to result from the need of companies to reduce expenses has not occurred. We see that the weak world economies have caused the behavior of outsourcing buyers to shift to accommodate their changing financial needs. Although economic conditions have forced companies to delay necessary strategic projects, as the recession continues more and more companies will find that they cannot indefinitely put their outsourcing plans on hold and, therefore, new deals will continue to be slowly unlocked. In many cases, these will be shorter-term, more tactical initiatives. But even some of the larger projects that are currently grinding glacially through internal approvals will finally be done. For example, there are a number of large integration exercises where two or more big banks have come together, which, once those exercises have been completed, will require the merged entity to focus on its going-forward strategy. That in turn will generate new projects. The projects, however, may take a different form from the traditional large-scale transformational deals as companies seek to rationalize their outsourcing relationships and make them more efficient.