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Global Sourcing Trends in 2007

By David Skinner (London), John Delaney (New York),
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At the start of 2007, we have once again surveyed the lawyers in Morrison & Foerster's Global Sourcing Group in key markets in the United States, Europe and Asia. This update collates their views on the state of the global outsourcing market and makes predictions about what to expect in 2007. Our views are based not only on what we have seen in the many sourcing projects with which we have been involved over the past twelve months, but also on the views of many of our clients, service providers and outsourcing consultant colleagues.

Twelve months ago, we predicted the further expansion of business process outsourcing (BPO), the growing maturity of the offshore market and the growth of multi-sourcing at the expense of single one-off "mega-deals". Each of those trends has developed over the course of 2006 and, in our observation, 2007 will continue these themes but at an accelerated pace. For example, not only has the mega-deal suffered but most deals are now both shorter in duration and smaller in value than two years ago. Clients are committed to outsourcing but are less prepared than in the recent past to be locked into long-term deals. Flexibility has become the new outsourcing mantra.

Our predictions for the sourcing market in 2007 are:

- a continued trend towards smaller, shorter deals as clients focus on individual processes instead of large, complex institutional transactions;
- increased reliance on global service delivery models;
- data privacy and data security issues will become ever more important to outsourcing customers;
- increased offshoring to Asia as clients become more confident about doing business in China;
- the outcome of the 2006 U.S. mid-term elections may lead to a revival of anti-outsourcing sentiment in the United States; and
- large Japanese companies will begin to adopt recognizable elements of IT outsourcing and BPO models into their traditional contract partnering modes of operation.

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OVERVIEW

Outsourcing remains a buyer's market. Increased competition from service providers at all levels enables customers to pick and choose with increased flexibility. Rather than risking whole business lines with a single service provider, shorter duration and smaller value transactions allow customers to spread operational risk and develop new relationships. Although this increases the governance burden for customers, this seems a price they are willing to pay. Handing over a broad set of service requirements to one single service provider often did not work for many customers.

Niche players are winning more deals at the expense of both the Tier 1 service providers and the sub-Tier 1 mid-range providers. While the outsourcing market continues to expand rapidly enough that the larger service providers can protect their earnings even with a reducing market share, the real potential losers are likely to be mid-level service providers who have not come up with a good strategy to overcome this problem. So, 2007 could be the year that many of the traditional big service providers change their focus and try and win more of the smaller deals.

GOVERNANCE

Multi-sourcing has now become the favored sourcing strategy. Customers have realized that it is not realistic for one service provider to be good

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at everything, and concentrating on "best of breed" is more likely to deliver value. This strategy comes with a cost because customers now need to spend more time and money managing their various service providers. We find that our clients are much more focused on governance than they were even two years ago and that they build on-going governance and retained organization costs of 8-15% into their business cases. However, many customers still struggle to manage their deals properly and project management will need to improve if multi-sourcing is to achieve its goals.

There are, of course, exceptions to this trend. Big deals are still being signed by the Tier 1 service providers – see Accenture winning the \$1.5 billion Unilever HRO transaction. The difference is that these large deals are now concentrated in fewer sectors and many larger deals are being broken up when they come up for renewal – the General Motors deal announced in early 2006 is a good example of this. Leading outsourcing consultancy TPI predicts that there will be fewer than 8 deals in 2007 with a

value in excess of \$1 billion, down from 15 in 2005 and 25 in 2004.

As deals become smaller and customers focus more on governance issues, we are noticing that deals are taking longer to close. There is a clear difference in approach between offshore-origin service providers (who remain fleet-of-foot and prepared to meet customers' expectations in order to close deals quickly) and larger (especially Tier 1) providers (who appear to have developed increasingly protracted and convoluted sign-off procedures and are reluctant to move away from their own pre-determined policy positions). Service providers in this latter group will need to ensure that they have factored their increased cost of sales into their bids and that they set realistic market expectations about their projected revenue streams.

BPO – SOME UP, SOME DOWN

Business process outsourcing will remain the fastest growing sector in 2007. More and more processes are now in-scope, both front and back office. HRO has not grown as much in 2006 as predicted, not least because service providers have struggled to deliver the savings and performance and the profit margins have also been poor. Hewitt and Convergys have both revealed less-than-expected performance data in 2006 and this has slowed much of the HRO momentum. Other areas, however, continue to grow.

Finance & accounting should be a growth area in 2007 as CFOs have moved on from Sarbanes-Oxley compliance issues to examine more internal processes. We have seen many of our insurance clients outsourcing their claims administration services to save costs and improve performance. The insurance sector should clearly remain a key buyer of outsourcing services, as companies are driven to reduce their costs further and skills shortages mean that outsourcing is being used to support the roll-out of new products.

OFFSHORING BECOMES GLOBAL SERVICE DELIVERY

2006 saw the convergence of onshore and offshore. More and more deals now involve an element of offshore delivery and we have also seen key offshore service providers coming onshore to win business.

For example, in March 2006 Morrison & Foerster client Pearl Insurance outsourced its payment execution services to TCS who came onshore to win this work (<http://www.mofo.com/news/media/files/pr02035.html>). In fact, many of the Indian-origin service providers now have delivery centers in all the key geographies. This has helped them win more deals from the Tier 1 service providers and to move beyond their typical strengths in applications development and maintenance (ADM).

Increasingly, service providers will be distinguished from each other – and selected by customers – based on the

robustness of the global service delivery model – *i.e.*, by their ability to source services delivery from the right place at the best price. This feature of the market was something that we investigated at a joint seminar with TPI in late 2006 (<http://www.mofo.com/events/seminars/files/seminar02147.html>).

2006 also saw more work being done in China and this trend will continue. Although India retains a cost and language advantage, China closes the gap year-by-year and is making major strides to close the significant skills gap for many types of outsourcing. Analysts have recently claimed that between 5-10% of U.S. and European IT software

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outsourcing will be diverted from India to China in a few years time. Certainly most of the major Indian service providers are already established in at least one of the major centers in China (Shanghai, Beijing and elsewhere), as are some of the U.S. service providers.

We have experienced our clients looking increasingly to China for ADM work in particular. Despite a regulatory regime that remains less friendly to business interests than that found in

India, the Philippines and other popular sourcing destinations, more companies are sending ADM work to China where the cost advantages are greatest.

We have seen deals won by Indian service providers that are then performed in China and we believe that this trend will continue. India will continue to be the largest offshore centre for at least the immediate future and more complex work will still be performed there for the moment. China will begin to attract more lower value work, especially ADM, and in particular in respect of non-business-critical software. We have also seen our clients set up their own development centers in China, usu-

ally as a joint venture with a Chinese partner, and this is done for traditional offshoring work as well as positioning companies to attack the Chinese domestic market. Operating in China still remains complex and we advise clients to invest enough time up-front to make these ventures work.

DATA SECURITY

Data privacy and security are now established as major concerns in out-

sourcing. Many global companies have become concerned that their outsourcing contracts do not fully protect them from security breaches, and consumers are also alive to this issue after several media exposés such as the recent UK Channel 4 Dispatches show that highlighted the issue of data theft at Indian call centers, and the sting operation conducted by a British tabloid newspaper last summer on data security breaches at another Indian offshore operation. In addition, Morrison & Foerster has been involved in recent research done by the UK's National Outsourcing Association which also demonstrated how data protection concerns loom large in the minds of companies contemplating outsourcing.

This trend will clearly continue in 2007 and much more effort will be put into ensuring that data security requirements are met and that customers are quickly informed of any security breaches by service providers. We will also be watching the regulatory situation with interest to see whether the EU follows the lead of the U.S. and Japan and "toughens up" its approach to dealing with leaks of personal data and breach notification. Global companies will continue to find ways to permit cross-border data transfers and we are advising more clients about effective policies, including binding corporate rules (<http://www.mofo.com/news/updates/files/update02268.html>).

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GEOGRAPHIC TRENDS

We do not see significant changes from 2006. The United States and the UK will continue to mature but continental Europe will be an important driver of new deals. TPI, for example, believes that more European companies are considering adopting the shared service model for their outsourcing deals.

In the United States, there has been speculation that the recent mid-term elections, which resulted in Democrats gaining control of the House of Representatives and the Senate, could lead to 2007 legislative initiatives aimed at outsourcing. Several Democrats won their seats while touting anti-sourcing and anti-globalization agendas. This echoes the anti-outsourcing debate of the last Presidential election which resulted in a slew of state-level anti-outsourcing legislation (<http://www.mofo.com/news/updates/files/update02031.html>). Additionally, some Democrats support tax reform aimed at discouraging outsourcing, although there has been no actual new legislation introduced at this time.

Asia still remains a major offshoring location but there are signs that some

Asian companies are beginning to look at elements of what might typically be seen as "Western-style" outsourcing. Japan has traditionally been a low user of services outsourcing, apart from contract manufacturing and some outsourcing of some services to Dalian in China. However, this may be beginning to change and there is increased interest in Japan at looking at the outsourcing model for more services. We are, for example, hosting seminars in Tokyo with TPI on outsourcing. Accenture has also reported that it is being asked for more proposals on outsourcing by Japanese companies.

CONCLUSION

We see continued growth of outsourcing in 2007, with smaller deals and a greater emphasis on BPO. The merging of the offshore and onshore delivery models will continue and service providers will continue to search for more competitive solutions in order to win customers. 2007 will remain a buyer's market. ■

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