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State of the Outsourcing Industry in Mid-2009: Activity To Resume With a More Cautious and Global Focus

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Like any significant business or IT investment or transformational exercise, most enterprises have put outsourcing plans on the back burner while they tackle fundamental issues, such as eliminating redundancies or engaging in M&A activity, not to mention contemplating their very survival.

However, AMR Research's latest study on outsourcing adoption plans clearly indicates this tide is about to change, with enterprises renewing their intentions to move into outsourcing environments (see Figure 1).

Application development and maintenance, IT infrastructure, and transactional business process outsourcing (BPO), all of which are high-growth areas with mature service provider offerings available at low cost and often low upfront investment requirements, are poised to resume a more aggressive adoption trajectory over the next year. We're anticipating some modest contract growth in 3Q09, with a notable spike in new contracts and existing contract augmentation in 4Q09 and 1Q10.

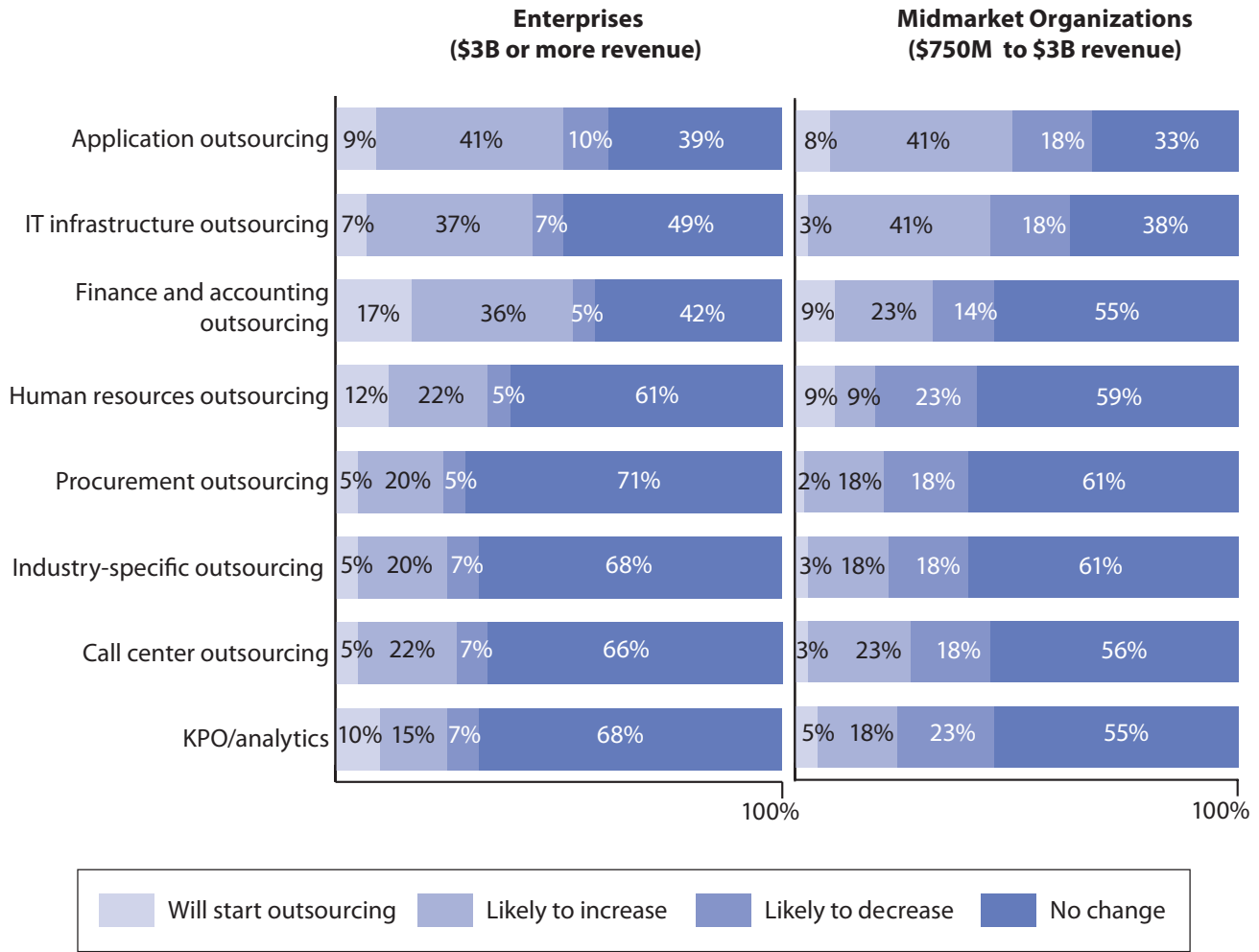
Consider the following key trends:

- Application outsourcing (AO) is already resuming, with a similar uptake to the pre-recession era: 8% of companies are moving into deals for the first time. 42% of existing buyers will increase scope, with only 18% decreasing. The midmarket is also showing an aggressive adoption curve, courtesy of a lower penetration of applications outsourcing engagements and increased movement from staff augmentation to managed services delivery models.
- IT infrastructure outsourcing shows a similar aggressive trend to application outsourcing, with a similar number increasing and decreasing scope. However, new customer penetration is much lower

with midsize firms (3%), which is largely a result of razor-thin business cases, where the cost/benefit of outsourcing infrastructure services is not as attractive as the application space.

- Finance and accounting (F&A) business process outsourcing has already resumed its pre-recession surge, with 13% of companies looking to make their first venture in an F&A BPO model. 30% of existing buyers are increasing scope and only 17% are decreasing. The large enterprise market is clearly more aggressive because of the higher cost savings offered by broader scale labor arbitrage.
- Human resources outsourcing (HRO) will be more modest, with 10% looking at payroll-based engagements for the first time. However, the same number of current HRO buyers that are increasing scope will also be decreasing scope. Clients that have adopted HR outsourcing seem to be sticking with what they've already outsourced, as opposed to bundling more processes.
- Procurement BPO shows steady potential, although it's a lot less pronounced than on the F&A side. It appears to be slowing after an aggressive growth phase in recent years.
- Analytics or knowledge process outsourcing (KPO) is being evaluated by 8% of buyers. It seems to be more project focused, with companies figuring out what works as opposed to increasing scope.

Figure 1: Overall outsourcing plans over the next 12 months



Q. Overall, in light of the recession, are you more or less likely to increase your investment in the following IT-BPO services in the next 12 months?

n=127

Source: AMR Research and Global Services Media, 2009

Drivers and inhibitors behind outsourcing reflect the new economy

A recent **McKinsey** study revealed that 70% of consulting engagements are focused on cost reduction and only 30% on new revenue generation. Although the onus on firms is to drive out as much cost as possible—close to four-fifths view cost reduction as the primary driver for outsourcing—other factors are becoming crucial for planning as they evaluate outsourcing business models: more effectively globalizing their businesses, re-engineering business processes, and accessing expertise from service partners.

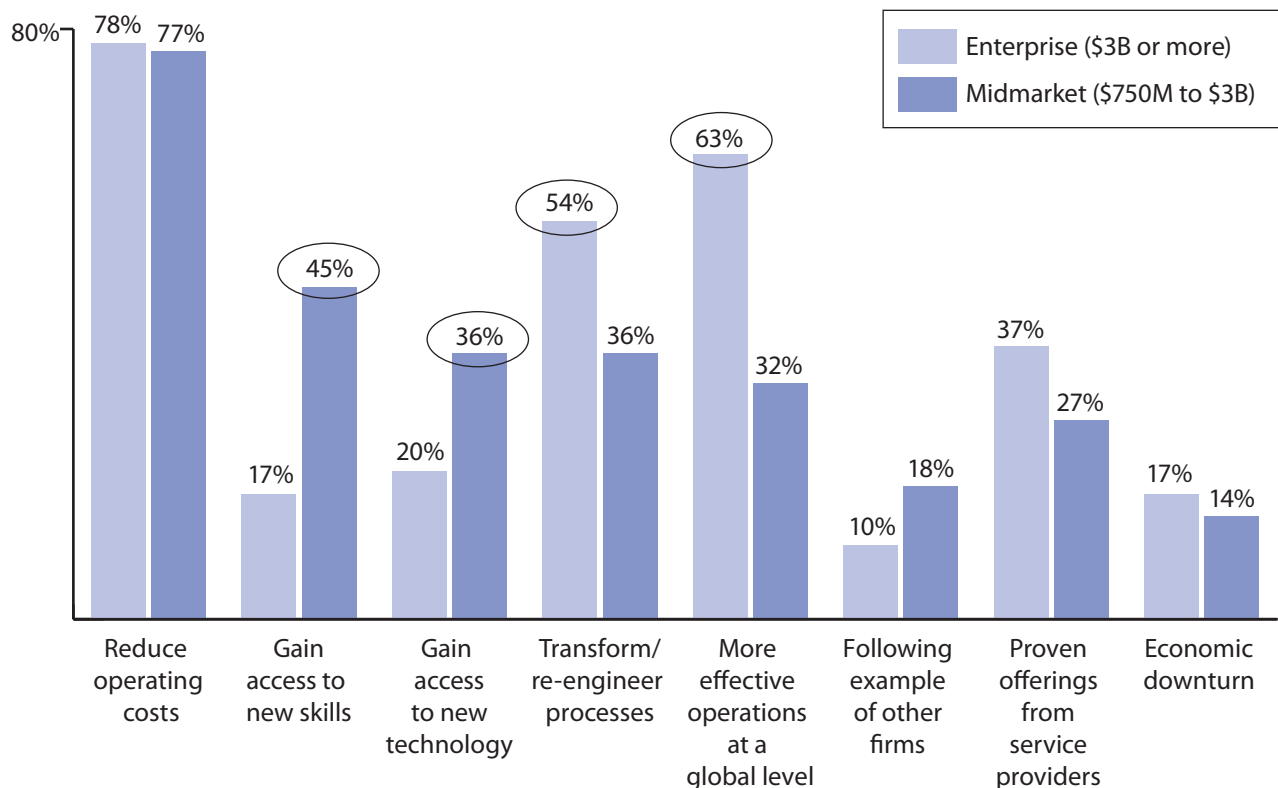
Unlike pre-recessionary days, the very nature of these outsourcing engagements will be more global in nature and will not involve significant upfront capital expenditure.

Large enterprises view outsourcing as a vehicle for globalization

If there's one thing this recession has taught us, it's just how integrated global economies and markets are. Businesses need to adapt to move in and out of diverse regional markets. They must make rapid decisions to invest or divest global service and product lines in order to prosper.

While some firms are finding it hard to make radical decisions in this downturn, others are clearly addressing the need to operate as a global business. This is especially the case with large enterprises (more than \$3B in annual revenue), with 60% of enterprises viewing this as a very important factor in their outsourcing decision making (see Figure 2).

Figure 2: Key drivers behind outsourcing uptake in today's economy



Q. How important are the following business drivers behind your company's outsourcing decision-making this year?
Answer = Very Important

n=127

Source: AMR Research and Global Services Media, 2009

In addition to globalizing their businesses, over half of large enterprises (54%) are considering outsourcing as a vehicle for re-engineering their business processes. Many firms have used the recession as an opportunity to focus heavily on eliminating waste and streamlining poor process flows. This has put them in a much healthier position to move into outsourcing environments that can be underpinned by robust ERP and standardized processes. Outsourcing can provide a valuable change agent for enterprises to drive these fundamental, transformative measures through to fruition.

But many firms in pre-recessionary times haven't been so diligent. Companies opted for "lift-and-shift" outsourcing engagements, where they transfer job functions from onshore staff to lower cost offshore labor, with limited upfront process re-engineering. Inefficiencies are magnified several times over in an outsourced model. Customers also must focus on a 72-month program of process transformation and technology investment, not a short-term, 24-month "cost take-out" exercise, where they use a service provider to take on their back-office baggage and grant it cost savings.

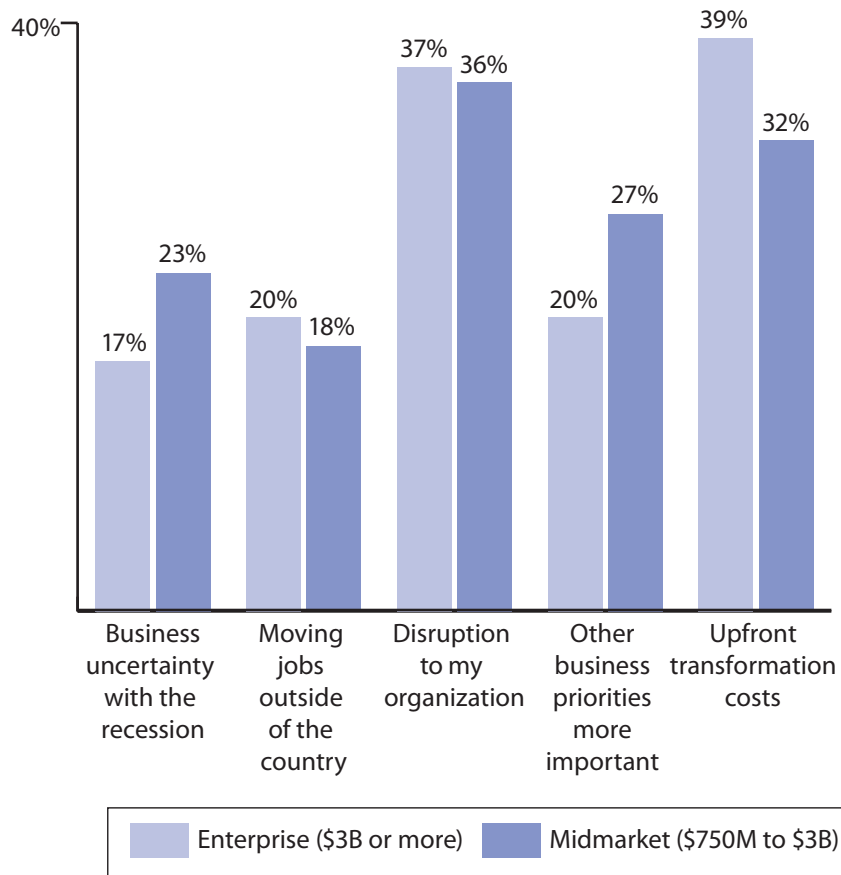
While large enterprises are focused on improving their processes during outsourcing, only a third of midsize companies (those with \$750M to \$3B in annual revenue) view process transformation as a very important factor. Beyond cost reduction, 45% cite their need to access new skills as very important. For example, many of our midsize clients are seeking to move into broader managed service agreements to gain better (and more cost-effective) access to application development and

support skills. This approach allows them to develop long-term relationships with service provider talent than can work onsite with existing staff, in addition to providing low-cost support from offshore locations.

Disruption and upfront investment are impediments behind new outsourcing adoption

While the drivers behind both midsize and large organizations have clear differences, the factors delaying decisions are remarkably similar (see Figure 3).

Figure 3: Key inhibitors behind outsourcing uptake in today's economy



Q. How important are the following factors in PREVENTING your company from outsourcing IT or business processes this year?

Answer = Very Important

n=127

Source: AMR Research and Global Services Media, 2009

While companies are tackling severe economic conditions, priorities are focused on critical management decisions surrounding business focus and ensuring company stability through the volatility and uncertainty. The upheaval of moving complex processes over to third-party providers and offshore locations is a challenge we've documented many times. As a result, it's giving many firms pause.

In addition, upfront investments in transformation costs, such as new software, consulting, and process engineering, are a major impediment in this market. There are already several partnerships between software-as-a-service (SaaS) application vendors and BPO service providers where they are offering more OPEX-based services. In this arrangement, the buyer moves directly onto a common set of process standards, with the service provider offering some of the transformation costs upfront to ease the initial cost burden.

But shaving a few percentage points off the bottom line is no longer a game changer when companies are facing crucial decisions over their very survival. Service providers have bulging sales pipelines these days—the problem is persuading prospects to sign contracts. Outsourcing major parts of support operations needs to be treated in light of the next 10 to 15 years for a company, not solely the next quarter on the balance sheet. Hence, there can be positive sides to uncertainty and fear.

Surprisingly, barely a fifth of companies state that jobs moving outside the country is an important inhibitor to outsourcing, which doesn't reflect the media spotlight. It appears that while many people can voice projectionist views, when it comes to driving cost from their corporate bottom lines, it's a different story.

What next for the outsourcing industry?

As the fog slowly lifts from the recession, companies are focusing more than ever on cost containment, and outsourcing is clearly a vehicle for driving out expense from the bottom line. However, it needs to be combined with ongoing business transformation initiatives. Many companies in the past tried to exploit outsourcing to take too much cost out too quickly and were forced to pay the penalty. Outsourcing will come back (it already is), with double-digit growth predicted over the next few months. Don't expect to see as many mega deals as yesteryear, however. Instead, they'll be cautious, smaller scope engagements focused on lower upfront capital expenditure and supported by low-cost offshore and nearshore resources.

To accelerate onboarding, cost savings for clients, and margins for themselves, expect service providers to intensify the development and marketing of standard outsourced products across infrastructure, application, and business process categories, including cloud computing, software as a service, and platform-based business process outsourcing. For infrastructure capacity, it's clear this trend already has buy-side and sell-side legs. For applications and business process outsourcing, it's still nascent, with formidable challenges with user acceptance. We're still waiting for signals from the buy side that show broader willingness to accept standard solutions, a la **ADP**. Outsourcing today and in the near term to midterm still means adoption of bespoke solutions and contract arrangements.