;login:

THE MAGAZINE OF USENIX & SAGE
June 2003 • volume 28 • number 3

inside:

THE LAW

Trends in the Outsourcing Industry

by John Nicholson

USENIX & SAGE
The Advanced Computing Systems Association &
The System Administrators Guild

trends in the outsourcing industry

by John Nicholson

John Nicholson is an attorney in the Technology Group of the firm of Shaw Pittman in Washington, D.C. He focuses on technology outsourcing, application development and system implementation, and other technology issues.

John.Nicholson@ShawPittman.com

In my last column,[1] I talked about some of the common reasons why outsourcing deals go badly and ways to avoid those problems. The purpose of this column is to discuss some of the current, macro-level trends in outsourcing with regard to (1) the vendors providing the services, (2) the services themselves, and (3) the customers receiving the services.

The Vendors

Trend 1 – Vendors Becoming Public Companies

The market for global outsourcing services is a somewhat unsettled area. Based on size and resources, the "Tier 1" providers are IBM, CSC, EDS and, according to some, ACS. Behind them are the "Tier 2" providers: Perot Systems, CGI, Accenture, Unisys, Lockheed Martin, and Siemens. In addition, hardware manufacturers like Hewlett-Packard and Dell are trying to move into the more lucrative IT services business.2 Also, some new, offshore players like Tata Consulting Services ("TCS") are trying to expand into the US market.

Right now, IBM is the dominant player in the global outsourcing market. This is not because IBM has distinguished itself in terms of capability, service quality, or price (no global services vendor has). It is simply a reflection of some challenging leadership and financial circumstances faced by the other Tier 1 players[3] (a point happily emphasized by the IBM salespeople) and the old hardware adage that "No one ever got fired for buying IBM." IBM recognizes and exploits these advantages whenever possible.

What used to be the consulting arms of the "Big Five" have all morphed in some way and, with the exception of Braxton, are all now publicly held companies:

Yesterday	Today
Andersen Consulting (created as part of Arthur Andersen, then "separated" into an arm of Andersen Worldwide)	Accenture
PricewaterhouseCoopers	IBM
KPMG	Bearing Point
Deloitte Consulting	Braxton
Ernst & Young	Cap Gemini Ernst & Young

The public nature of these companies has two important consequences. First, public companies are subject to the vagaries of the market. Hardware and software companies are already driven by quarterly and annual results, and these now-public service providers will be subject to the same forces. Securities industry analysts are beginning to have concerns about continued growth in the IT services and outsourcing industry because of reduced backlogs, longer lead times to conclude transactions, and a general downturn in the industry. This could be due to general issues with the economy, maturation in the industry or some customer dissatisfaction with the outsourcing model, performance, price, or something else entirely, but, regardless of the cause, it affects the stability of public outsourcing vendors. Second, these companies use their stock as compensation, and as the value of their stock decreases, their ability to attract and retain talent decreases as well.

You're shipping your company's crown jewels halfway around the world, where they are subject to all kinds of possible threats.

The Services

There are two major types of outsourcing deals being structured in the market today: IT outsourcings ("ITO") and business process outsourcings ("BPO"). The market for ITO deals is much more mature, and the deals are fairly well understood.

Trend 2 – Offshore Outsourcing

The hot area in the US for ITOs is offshore outsourcing, either on its own or as part of a larger transaction.[4] Offshore outsourcing is attractive because of its price (currently a factor of 5 to 10 times less expensive than using domestic providers) and the quality of the services provided.(Most Indian vendors have been certified by the Software Enterprise Institute as achieving "Level 5" of the Capability Maturity Model.)[5]

Currently, the main location for offshore ITOs is India, but the demand for technology workers in India is beginning to outstrip the supply, which is driving up the cost of services in India. While services in India are still substantially less expensive than those available in the US or Europe, services provided in China, Eastern Europe, Malaysia, the Philippines, and Russia are becoming more attractive.[6] The major players in offshore outsourcing are divided between the larger firms listed in the previous section, each of which either has its own offshore operations or a close tie to an offshore provider, and the native, "pure-play" offshore companies such as TCS, HCL Technologies, Infosys, Wipro, and Cognizant.

In addition to increasing competition from other countries, the challenges for offshore providers are:

1. The ability to scale their operations while maintaining quality – The fundamental premise of outsourcing is that an outsourcing provider whose core business is providing technology services can provide those services to multiple customers at a lower cost. As more companies move IT operations offshore, the Indian vendors may not be able to maintain the level of quality for which they have become known.
2. Business continuity – The distance between the US and India, combined with the level of infrastructure in India, also raises some questions regarding disaster recovery and business continuity. On one hand, having facilities on the other side of the globe provides some redundancy, but, the very real issue is that your outsourced operations in India are being performed in a country with nuclear weapons that is on unfriendly terms with its next-door neighbor, which also has nuclear weapons. For offshore ITOs that go through one of the larger global providers that has operations or a close alliance with an offshore provider, this can be mitigated by the global provider.
3. Customer concerns related to confidentiality and non-disclosure – You're shipping your company's crown jewels halfway around the world, where they are subject to all kinds of possible threats. What if something gets disclosed? What if an employee takes a copy of your data to a competitor? How will you be able to protect yourself? What remedies will you have against the outsourcing vendor? These are probably the areas that concern potential offshore outsourcing customers the most. In the case of India, the local outsourcing vendors understand the concerns of US companies and are generally willing to agree to contractual terms that are satisfactory to the customer – including robust audit and inspection rights. (Note, however, that you must actually *exercise* those rights by performing the audits and inspections.)

The Indian companies understand the economic value of providing outsourcing services, and they recognize the risk to their economy if foreign firms do not feel safe with regard to confidential information. This is also an issue that can be addressed by contracting with one of the larger global providers. However, this may become more of a real issue as outsourcing moves to countries like China, where there has been a history of intellectual property concerns.

The ability of a customer to renegotiate is strengthened by strong, clear, termination-for-convenience provisions in your agreements.

Trend 3 – Business Process Outsourcing ("BPO")

While the ITO market, including the offshore services market, is relatively mature, with large, multi-disciplinary deals a relatively regular occurrence, the BPO market is far from mature (contrary to what most vendors will try to tell you). The earliest form of limited BPO has been going on for decades – payroll processing. Other limited-scope BPOs include HR, finance/accounting services, call centers, and claims processing, but until a large, multi-disciplinary, "shared services" outsourcing agreement is successfully completed and implemented, the BPO market cannot be considered mature. This isn't likely to happen until one of the Tier 1 providers purchases some large company's shared services functionality and resells those services to other customers.

Some people believe that because a BPO provides a "higher" level of functionality (i.e., an ITO provides the services that enable business processes to be performed, a BPO provides the services that touch the end user/customer), it should be easier to identify, structure, and complete a BPO transaction. The opposite is true. Because fewer models for BPOs exist, and because vendors have less experience in structuring BPOs, it is important for both customers and vendors to focus on the correct statement of work with appropriate service levels and pricing. Although the functions included in a BPO are supported by IT services, they are significantly more complicated and involve more unique activities performed by personnel. Because of this, BPO services may be less fungible among the customers of a given vendor, making the outsourcing economic model less viable.

Because of this uncertainty and immaturity in the BPO marketplace, it is important for BPO customers to spend the necessary time and energy to get these deals structured correctly. One of the most important things for an outsourcing customer to do is to understand *in detail* exactly how the vendor proposes to provide the services. Vendors will resist providing this information. They know that once they are in the door and performing the services, you are unlikely to kick them out, due to the pain of bringing in a new vendor. However, acquiring a detailed understanding and documentation of exactly what the vendor will do and what the vendor will charge for it is the only way for a customer to evaluate whether the savings promised by the vendor are actually achievable and whether the pricing structure makes sense.

The Customers

Trend 4 – Renegotiation of Existing Agreements

Another issue that outsourcing vendors are facing is that their customers have also been hit by the economic downturn. These customers, who initially signed outsourcing deals on the promise of significant savings, are now demanding further concessions and renegotiating deals to reflect lower volumes. Frequently, the pricing structures designed when the agreements were originally signed are not appropriate to address the new situation, and in the new negotiations customers are even more focused on price.

The ability of a customer to renegotiate is strengthened by strong, clear, termination-for-convenience provisions in your agreements. When negotiating with vendors at the beginning of a transaction, make sure that you have the ability to terminate for convenience. Frequently, vendors will agree to allow you to terminate a contract early provided that you give them notice and pay a termination-for-convenience fee.[7] If you terminate the contract early, it isn't unreasonable for a vendor to recover costs that the vendor expected to recover during the term. The vendor shouldn't suffer harm because you elected to terminate a contract early. However, once you terminate the contract, the vendor won't be providing services or incurring costs, so there is no reason for the vendor to receive the total revenues that the vendor would have received for providing the services during the remainder of the term.

Nor is there much ground for the vendor to argue that it should receive the profits that it would have received during the remainder of the term. Vendors will try to use the argument that they have a right to lost profits because they shouldn't suffer harm because you decided to terminate the contract early. If the contract had never happened, the vendor would not have received the profits that they are trying to claim, so allowing the vendor to include lost profits in a termination-for-convenience charge puts the vendor in a better position than if the deal had never happened. The vendor should be allowed to recover costs, but not lost profits.

By understanding the economic forces driving outsourcing vendors, you can renegotiate with them for a better deal. Just as you can negotiate with hardware and software vendors who need to make their end-of-quarter or end-of-year numbers, you may be able to negotiate with outsourcing vendors in the same way.

Trend 5 – Piecemeal Deals

Given the fact that negotiating outsourcing deals is a lengthy process, companies are trying to expedite their deals by breaking up the scope of services and negotiating multiple deals rather than one large deal. This is the wrong approach for several reasons: first, the larger the scope of the deal, the more negotiating leverage you have with the vendor; second, negotiating outsourcing deals is a very resource-intensive process for the customer, and doing more, smaller transactions is much less efficient; third, outsourcing can lead to morale problems until the deal is finished, and doing multiple deals just extends the uncertainty for the customer's workforce and creates the potential for extended morale issues; fourth, vendors will use the multiple negotiations as opportunities to re-negotiate provisions that came out in the customer's favor in earlier deals. For BPOs, in particular, the preceding sentence is still true, but the customer needs to recognize that BPO services are less mature, and, therefore, the customer will need to pay much more attention to the scope, service levels, and pricing of the transaction.

Piecemeal deals significantly increase the cost and risk to the customer.

Conclusion

Economics and the maturing nature of the industry are driving many behaviors in the outsourcing industry, and by understanding them you can help your company deal with vendors. Because vendors and customers will increasingly be focused on the short-term bottom line, it is increasingly important that each party spend the time and energy to first get a deal right and then keep it on track. The relationships between the vendor account team and the customer's program management will determine whether outsourcing relationships succeed.

NOTES

1. "Common Problems with Outsourcing Deals and How to Avoid Them," *;login:*, vol. 28, no. 1, February 2003, pp. 6–10.
2. See Kennedy, Siobhan, "HP Eyes IBM with Multibillion-Dollar Deals," Reuters, April 11, 2003, as posted at *http://biz.yahoo.com/rb/030411/tech_hewlettpackard_5.html*.
3. See, for example, Bonasia, J., "EDS Investors Watch New CEO," *Investor's Business Daily*, April 14, 2003, as posted at *http://biz.yahoo.com/ibd/030414/tech01_1.html*; and "Accounting Fears Hit Computer Sciences," Reuters, April 2, 2003, as posted at *http://biz.yahoo.com/rb/030402/tech_computersciences_stocks_1.html*.
4. The potential for offshore outsourcing is limited in Europe by EU data privacy regulations. Since these rules regulate the transfer of data outside the EU, using an offshore vendor may not be possible for many European companies.
5. For more information, see *http://www.sei.cmu.edu/cmm/cmm.html*.
6. See Chai, Winston, "Outsourcing haven India running out of techies," *http://www.silicon.com*, February 18, 2003. See, also, "Gaining Ground," *Information Week*, March 31, 2003, *http://www.informationweek.com/story/IWK20030328S0003*.
7. Note that there is a difference between "termination for convenience" and "termination for cause." Termination for cause is when the vendor has breached the contract in some way and you are firing the vendor. Termination for convenience means that you have simply decided that you don't want the services anymore.