

# Outsourcing predictions for 2008

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It has been a dynamic year in the IT outsourcing industry.

The Indian rupee rose to record levels, while the US dollar declined against most major currencies, impacting global IT service providers and customers alike.

Merger and acquisition activity went into high gear (with the exception of poor Affiliated Computer Services, which tried - and failed - to go private for the second time).

The consolidation activity was most notable for the inroads Indian providers made into the US market by buying local providers. And Mumbai-based Tata Consultancy Services announced a \$1,2bn IT service deal with The Nielsen Company, technically the biggest offshore contract to date, hinting at the increasing maturation of the outsourcing market. Buyers of IT services also began to look beyond India to balance their offshore outsourcing portfolio, from Shanghai to São Paulo and more than a few spots in between.

According to the predictions IT outsourcing analysts are making, the headline for 2008 in the IT service market could be "the more things change, the more they stay the same". Experts expect the rupee to continue its rise, keeping global IT service providers and customers on edge. Industry consolidation will continue. The offshore outsourcing market will continue to develop, in India and beyond.

But don't expect everything to remain status quo in 2008. This could be the year when call centres shape up, IT service providers figure out a way to provide more of the innovation that their clients crave, and outsourcing customers finally get smart. Read on for more trends to keep an eye on in the new year, and add your own forecasts.

## **1. That darn dollar**

The India rupee has risen by more than 11% in value against the US dollar so far this year. In the absence of government intervention, it has nowhere to go but up. The continued decline of the dollar could be difficult for service providers to absorb.

During 2007, Infosys reported a currency impact of 2,8% on Q3 profitability, Wipro contemplated six-day workweeks, and EDS and Mphasis considered billing clients in rupees, while customers kept a close watch for other symptoms of currency stress. If the currency gap widens next year, expect Indian outsourcing providers (and multinationals with a big presence on the subcontinent) to start indexing their prices to local salaries, promoting other offshore locations like China and Latin America, delay hiring of new staff, and building currency hedges into contracts, says offshore outsourcing consultancy, neolT.

Oh, and Canada? With the loonie having edged off the greenback, the US neighbour to the north's days as an attractive nearshore outsourcing destination are numbered.

## **2. Caution: consolidation ahead**

They are cash-rich. They have high market valuations. And they are hungry for customers. They are the industry's leading providers and you can expect them to gobble up smaller competitors in 2008.

Tier-2 providers like ACS, Perot Systems and others have struggled, unable to attain the 30% growth of global providers and lacking the scale of IBM or EDS. As a result, they will become acquisition targets for larger providers or private equity firms, says neoIT. (It may be third time lucky, ACS!)

US-based providers may be more likely to acquire midsize providers than their offshore brethren. Wipro got attention for its purchase of US-based infrastructure service provider Infocrossing in 2007, but caution will rule the day for Indian vendors in 2008. They will be unlikely to purchase a vendor with more than \$1bn in annual revenues, posits neoIT.

Indian IT service providers, however, will continue to set up local delivery service centres in the US, Europe and Latin America, says outsourcing adviser EquaTerra. Likewise, American and European service providers will continue expanding their offshore presence to remain price competitive. PA Consulting Group predicts the emergence of more alliances between Western and Indian companies this year, as well.

## **3. The politics of outsourcing**

During the 2004 US presidential election, moving offshore was a major topic of debate. Outside of the political arena, leading industry providers and their customers avoided big announcements in hopes of deflecting potentially negative publicity. (They weren't always successful. Thanks a lot, Lou Dobbs!)

The 2008 election? Not so much. Offshore outsourcing hasn't made the short list of issues being debated by would-be leaders in 2007 and neoIT doesn't expect it to gain traction. Nonetheless, industry leaders and offshore customers will continue to hold offshore cards close to chest. NeoIT expects large companies to avoid announcing substantial agreements or employee reductions during 2008.

Apparently, the phrase 'no publicity is bad publicity' still does not apply in the IT service field. The result could be a backlog of unsigned agreements pushing into 2009, says neoIT (which could put customers in the driver's seat during negotiations this year).

## **4. Passages beyond India**

Let's just establish this fact first: India will remain the market leader in offshore IT services. Period.

However, as the Indian market continues to be impacted by wage inflation, talent attrition and infrastructure strains, clients are looking outside the subcontinent for alternatives, say experts. Some companies with captive centres in Bangalore worry that the costs there could equal what they'd spend at home within five years, says neoIT. Thus, 2008 will be the biggest year to date of expansion of IT service delivery capabilities beyond

India. Think Latin America, Central and Eastern Europe, China, and, to a lesser degree, the Middle East and Africa.

And while everyone else has been focused on India for the past half a decade, alternative locations across around the world have been quietly investing in the necessary infrastructure (roads, airports, telecommunications, education, etc.) to attract IT and business process services, says neoIT.

That is good news for customers who suffered through India's growing pains, if, indeed, these emerging locations can leapfrog India on those issues. Of course, none of these new offshore destinations, with the exception of China, has the potential scale of India. But for now, the intent is to supplement India, not to replace it.

## **5. Flight from the big cities**

In India and beyond, outsourcing hot spots have become oversaturated, so many providers and customers are looking to set up shop elsewhere. Call it the exodus to the tier-2 cities and expect to see more of it in 2008.

The Indian economy overall is growing at 9% a year. A shortage of talent is emerging in the top cities across India, local universities are no longer providing an adequate number of qualified candidates, and recent tier-1 city grads are increasingly wary of starting at the bottom on the graveyard shift because they have other options, according to neoIT. That's creating movement into smaller, less saturated cities.

And India is not alone. Monterrey, Mexico, for example, is projecting a shortfall of software engineers in 2008. And the same story is occurring in dozens of outsourcing hot spots around the world.

As a result some IT service providers are jumping to second-tier cities from the get-go, in an attempt to sidestep the rush to set up shop in a major metropolis. "You can take some of the best practices from India and look at second-tier cities to set up a large centre," says Juan F. Ferrara, chief operating officer for the Americas for India-based IT service provider, Genpact. "You're already seeing that in Brazil and Argentina...where companies are already in second- and third-tier cities."

## **6. The new, new sales pitch: transformation**

Forget cost-cutting and efficiencies. Outsourcers are going to pitch themselves as partners in business transformation. Think you've heard that before? You have.

But this time they mean it. So say the experts. Customers want more than cost savings. They want access to great talent, vertical expertise, process maturity, flexibility, the great and powerful 'value add'. IT buyers want an outsourcing provider who can actually enhance the client's revenues and not just their own, says PA Consulting. So if vendors want to keep attracting those clients, they are going to have to pony up.

"All companies are realising that an IT outsourcing contract is valid for about as long as it takes the ink to dry on the signature page," says Shawn Fields, vice-president of managed services at Optimus Solutions. "Vendors who understand this and build

flexibility into their contractual structure that allows their clients to change services will find themselves distancing their companies from their competitors. Innovation will emerge as a deciding factor for IT outsourcing competitors."

Even in areas that are typically cost-centric, like offshore application development and maintenance, the emphasis will shift pure labour arbitrage projects to higher-value work such as process improvement and application portfolio rationalisation, according to the Everest Research Institute.

The catch is, of course, you'll have to pay more. Just like we told you. Forrester notes that rates for consulting services are already on the rise, and warns that IT service buyers can expect to spend more on outsourcing services in 2008 while deciphering which market changes warrant the upcharges and which don't.

## **7. Remote infrastructure management (RIM) grows up**

Remote infrastructure management (exactly what it sounds like: managing servers, databases, networks and security, and applications from offsite) has been possible for several years. But next year may be the year when buyers really grasp this alternative to infrastructure outsourcing.

These asset-light deals—so called because the provider does not take on the assets such as the client's data centres or desktops as part of the contract—will increase as clients get used to the idea that the "command and control" centre can be physically removed (and in the case of this largely offshored RIM option very far removed) from the physical data centre.

To date, this segment of the outsourcing market has been growing at about 20% a year, according to neoIT. The Everest Research Institute predicts the RIM market will pick up to the tune of 60 to 70% growth in 2008. Besides increasing comfort levels with the RIM concept, neoIT also suspects that an economic downturn in the US could fuel greater demand for the lower-cost infrastructure outsourcing option.

And the transitions can happen on the fly: most data centres and network operating centres (NOCs) are managed with a common set of tools, service providers already possess operational expertise in them, and adaptation to any client-specific needs can happen relatively quickly, says neoIT.

Asset-light deals could be a boon for IT service providers, as the profit margins are better than the traditional infrastructure outsourcing model. However, there is a downside for vendors. An asset-light deal brings in about 70% less in total contract value to the provider than the traditional, assets-included deal, says Everest Research Institute. Net result: better profit margins, but less top-line growth. But, experts say it's the way of the future. As a result, traditional infrastructure outsourcing will itself show a decline...but not until 2010, says Everest.

## **8. Call centre call to arms?**

Call centres are the most mature segment of the offshore outsourcing industry. And yet...they're not. Clients have become dissatisfied with the sweatshop mentality that leads to turnover levels from 60 to 150% a year, says neoIT.

Part of the problem is, of course, the nature of call centre work. One industry provider reports that it loses half its staff during the first 100 days of work, says neoIT, but turnover levels out after that.

Nonetheless, clients are demanding improvement. And providers are beginning to respond, says neoIT, by creating more 'client-centric' solutions, such as unique scripts and efforts to connect employees to the client's corporate culture. NeoIT predicts that call centre operators will up the ante in 2008, assessing new locations and allocating personnel to customer-specific solutions centres instead of having massive pools of personnel taking calls for multiple clients.

## **9. The death of the megadeal (really)**

The end of the outsourcing megadeal - those \$1 billion-plus contracts that get the most attention from the media - has been portended for three years now, but this year may be the year those predictions finally come true.

Why?

It's simple. "Few Fortune 100 companies remain that could sign new megacontracts," says Ross Tisnovsky, vice-president of IT outsourcing Research at Everest Research Institute.

Of course, big outsourcing deals won't disappear. The focus will be on their renewals and renegotiations, and outsourcers will take the pricing gloves off to woo clients away from their incumbent providers. "We expect buyers will gain pricing benefits due to the pressure suppliers will have to grow signings and contend with increased competition for contract renewals," says Tisnovsky. "We also foresee long-term price decline in the (large enterprise) infrastructure outsourcing market due to an influx of new suppliers and increased competition."

## **10. Green clauses hit contracts**

Although "green" IT service is little more than marketing hype to date, the trend will take root and become measurable and attainable, says neoIT. While that's debatable, one thing is certain - interest is going to increase among outsourcing customers this year. More than 21% of publicly traded companies that outsource have added "green policies and performance" demands to their vendor contracts in 2007, and 94% plan on adding such clauses during renegotiations, according to the Brown Wilson Group.

That may light a fire under outsourcing providers to decrease their carbon footprints by creating greener data centres, investing in environmentally friendlier buildings and campuses, and developing eco-friendly processes and policies.

This is an area where smart small to midsize IT service firms will put a stake in the ground. "A smaller player can be audited more easily, can take carbon reduction

measures more easily and can be more flexible about changing traditional practices," says UK-based outsourcing researcher, Mark Kobayashi-Hillary. "It could be a great source of market differentiation."

### **11. Outsourcing buyers get smart(er)**

In 2008, many outsourcing customers will be entering third and fourth generation outsourcing contracts - either renewing, rebidding or restructuring their deals. And according to PA Consulting, many of those IT organisations have honed their internal capabilities for vendor management and governance over the years.

That maturity means that they are making smarter decisions, negotiating better terms, demanding better business-driven metrics and getting better at outsourcing lifecycle management. They may also start to create contract terms that shift more of the risk to their IT service vendors, says neolT.

Of course, there will be plenty of new entrants to the outsourcing market in 2008 who may choose to learn their own outsourcing lessons the hard way...and plenty of challenges in this dynamic market to test the veterans' hard-won skills as well.