

Ongoing Evolution in the IT Outsourcing Market

Findings from the Everest ITO RFI, 2007

Shiraz Ritwik, Research Director

Copyright © 2007, Everest Global, Inc. All rights reserved.



EVEREST
RESEARCH INSTITUTE

Executive Summary

The Application Development and Maintenance (ADM) and Infrastructure Outsourcing (IO) segments of the IT Outsourcing (ITO) market vary greatly in terms of growth dynamics and market trends.

Traditional IO suppliers are disproportionately focused on large buyers. The RIMO model, too, is evolving rapidly and is showing signs of convergence with traditional IO, as is evident from changes in pricing and buyer adoption.

ADM outsourcing is entering a phase of relative maturity, which is apparent in the diverse buyer industries served and the focus on large buyers. However, while the ADM activity of offshore suppliers is centered chiefly on labor arbitrage, traditional suppliers are becoming more creative around delivery and pricing. Offshore suppliers also have significantly smaller deals with large buyers, suggesting that they are still operating in a 'penetrate and radiate' mode.

ADM suppliers across categories are leveraging multiple offshore geographies for service delivery, reflecting the maturity of the global delivery model and suppliers' ability to handle the associated additional complexity.

Bundling of BPO and ITO deals is an infrequent occurrence and usually results in smaller contract values across suppliers. Both offshore and traditional suppliers derive the largest share of their signings from contracts that are a bundle of IO and ADM.

This paper discusses:

- Key messages from the latest Everest Outsourcing RFI 2007
- Data-driven conclusions on the market trends in ITO in general and the key market segments (i.e., ADM and IO)

Introduction: The Everest Outsourcing RFI 2007

To better understand key market trends and how they affect the mature IT outsourcing market, Everest conducted an ITO Request for Information (RFI) exercise in Q3 2007. The company analyzed a representative sample of responses from twelve ITO suppliers with headquarters in Europe, North America, and India. This RFI studied outsourcing transactions that fall into either IO or ADM outsourcing or consist of bundled IO and ADM offerings within a single contract.

To focus the inquiry on the high-value IT outsourcing market, Everest asked respondents to report their 25 largest ITO deals (by total contract value). Everest analyzed a total of 437 deals. The data assembled explains the behavior of the large buyers segment of the ITO market and is not directly applicable to smaller buyers with annual revenue less than US\$1 billion.

Summary of Infrastructure Outsourcing Trends

We segmented IO into two operational models: Traditional IO and Remote Infrastructure Management Outsourcing (RIMO). These models differ substantially in terms of maturity of the offering and buyer adoption trends. **Exhibit 1** shows the key differences between the models.

EXHIBIT 1

Models of infrastructure outsourcing

Source: Everest Research Institute

	Traditional IO	RIMO
Examples	Data center outsourcing	Remote server management
Scope of contract	Complete service delivery	Task or fractions of the function
Pricing model	Mostly output-based	Mostly input-based
Size of contract	Large	Small
Length of contract	Long (5-7 years)	Short (3-5 years)
Asset ownership	Very frequent	Very rare
People transfer	Very frequent	Very rare

Traditional IO suppliers showed relatively mature offerings. They focused primarily on large buyers (more than US\$10 billion in revenue), driving almost 80 percent of annualized contract value (ACV). Buyers also tend to sign longer-term, highly-bundled contracts with suppliers of traditional IO services: 69 percent of deals were multi-tower contracts (combinations of data center, network, desktop, and helpdesk outsourcing).

The RIMO model is evolving rapidly and is showing signs of convergence with traditional IO, as is evident from changes in pricing and buyer adoption

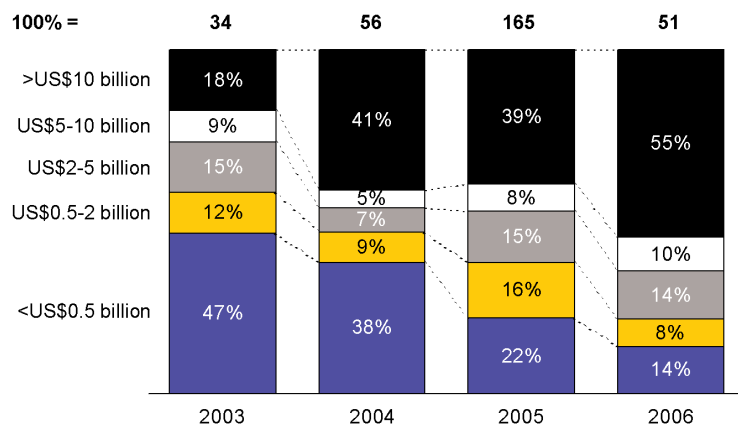
However, the RIMO model is evolving rapidly and is showing signs of convergence with traditional IO, as is evident from changes in pricing and buyer adoption. While medium-sized buyers (<US\$5 billion in revenue) drive more than one-third of RIMO deals, RIMO suppliers are steadily moving from serving small and medium businesses (SMBs) into the “big league”, focusing on larger buyer enterprises (see **Exhibit 2** for the RIMO trend). In addition, about 60 percent of RIMO deals are bundled, multi-tower contracts, reflecting increasing buyer confidence in RIMO suppliers.

EXHIBIT 2

Buyer adoption trends for the RIMO model

Source: Everest Research Institute

Deal distribution by buyer's annual revenue for RIMO suppliers
Number of the sample of deals analyzed



RIMO deals have predominantly utilized input-based pricing mechanisms, reflecting the rather basic value proposition of labor arbitrage. However, RIMO suppliers are now beginning to adopt output-based and combination pricing models in addition to input-based pricing, which is most likely a result of inclusion of transformational IO services into the RIMO work mix. This can also be traced to the capability-building efforts of large RIMO suppliers, many of whom have acquired specialized IO firms based in client geographies (e.g., Cognizant acquired Aimnet, Wipro acquired Infocrossing, etc.).

Buyers' preferences in sourcing infrastructure also vary across traditional IO and RIMO suppliers. The public sector buyers play a disproportionately higher role in traditional IO, accounting for 44 percent of the market by ACV. This is most likely because offshore delivery is the predominant driver of the RIMO model, and this does not enjoy a high adoption in the public sector. RIMO has also witnessed slower adoption in the Asia Pacific (APAC) region, where buyers appear to be hesitant to commit to large deals with RIMO suppliers.

Summary of ADM Outsourcing Trends

ADM outsourcing also consists of several business models. Our RFI effort focused on three largest business models in ADM outsourcing: application development, application maintenance, and system integration. Two distinctly different types of suppliers serve each segment: traditional on-site suppliers and offshore suppliers. **Exhibit 3** shows key characteristics of the ADM business models.

EXHIBIT 3

Models of ADM outsourcing

Source: Everest Research Institute

	System Integration	Application Development	Application Maintenance
Examples	<ul style="list-style-type: none"> Implementation of new software packages (e.g., ERP) Integration of new or existing applications 	<ul style="list-style-type: none"> Development of custom applications Significant enhancements to existing applications 	<ul style="list-style-type: none"> Ongoing maintenance and sustenance of existing applications
Form of activity	Project	Project/process	Process
Contract duration	Varies significantly	1-3 years	3-5 years
Delivery vehicle	Consulting project	Outsourced team	Outsourced team
Pricing model	Output- or input- based	Primarily input-based	Output- or input- based

ADM outsourcing is entering a more mature phase, which is apparent in the similarity of characteristics exhibited by traditional and offshore suppliers

ADM outsourcing is entering a more mature phase, which is apparent in the similarity of characteristics exhibited by traditional and offshore suppliers across key market metrics.

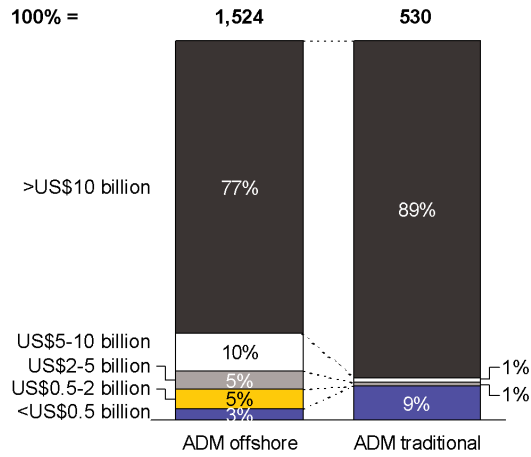
- Both supplier categories serve an equally diverse set of buyer industries and geographies. Financial services and manufacturing, distribution, and retail (MDR) are prevailing client segments for the RIMO, while traditional ADM suppliers predictably have a stronger focus on outsourcing in the public sector.
- Both supplier categories derive a large part of their contract revenues from large buyers with revenues above US\$10 billion (see **Exhibit 4**).
- There is no significant distinction in deal durations between supplier categories (the average ADM contract is signed for a duration of about four years across traditional and offshore suppliers).
- Finally, the low adoption of output-based pricing in ADM shows that staff augmentation is still the major driver for outsourcing activity across both supplier categories.

EXHIBIT 4

Buyer adoption trends for ADM suppliers

Source: Everest Research Institute

Deal distribution by buyer's annual revenue for ADM suppliers
ACV in US\$ million



Despite the similarities, there are subtle differences between the two supplier categories. While ADM activity of offshore suppliers is centered mainly on labor arbitrage, traditional suppliers are becoming more creative around delivery and pricing (risk-reward, gain-sharing, etc.), leading to higher instances of combination pricing in traditional suppliers' deals. Also, the fact that offshore suppliers have significantly smaller deals with large buyers suggests that they are still operating in a 'penetrate and radiate' mode for large buyer accounts.

The ADM market exhibits fairly interesting bundling trends. Only 27 percent of ADM deals are stand-alone, single-tower deals. Two towers are the most frequent form of ADM deal bundling, and buyers choose to outsource AD and AM together in one bundle in preference to other combinations. Buyers also typically bundle system integration (SI) with associated AD/AM activity. However, buyers frequently source application maintenance independently of other ADM activities.

Almost 30 percent of ADM deals are leveraging multiple offshore geographies for delivery, reflecting increasing adoption of the global delivery model and suppliers' ability to handle the additional complexity imposed by multi-region delivery. When looking at deals with single-region offshore delivery, however, India is the overwhelming choice of location. Also, India was present in 85 percent of all the deals that involve offshore delivery. Other regions like South America and Eastern Europe serve as nearshore centers for the North America and Europe geographies, but they still have some way to go in terms of location maturity.

Observations on Bundling Trends Across ITO and BPO

Bundling of BPO and ITO deals is an infrequent occurrence and usually results in smaller deals that accounted for less than 10 percent of the total signings in the sample

One of the areas of inquiry was to understand bundling trends not only within ITO, but also between ITO and BPO. We found that the bundling of BPO and ITO deals is an infrequent occurrence and usually results in smaller deals that account for less than 10 percent of the total signings in the sample.

The second interesting trend is that while stand-alone IO and ADM deals occur much more frequently, both offshore and traditional suppliers derive the largest share of their signings from contracts which are a bundle of IO and ADM.

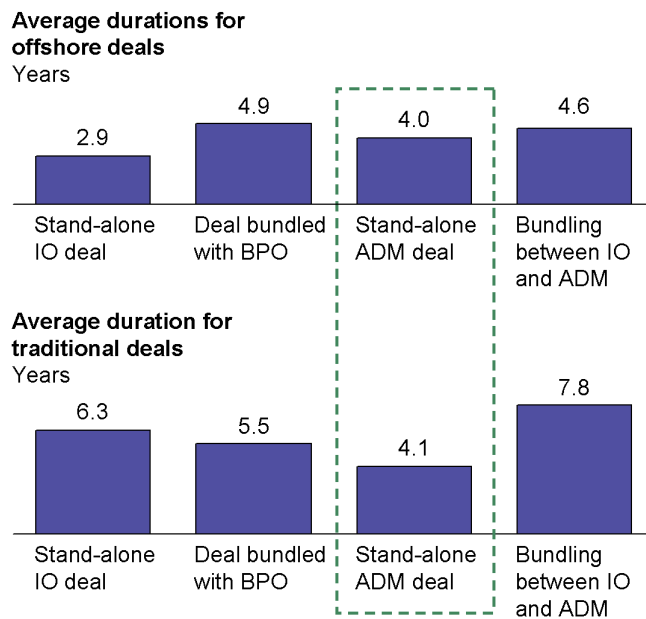
Thirdly, the functional scope of the contract often dictates choice of pricing models, e.g., the presence of IO in the scope of the deal drives the share of output-based / combination pricing across traditional and offshore suppliers.

Exhibit 5 shows that traditional suppliers exhibit higher deal durations across most scope combinations, except for stand-alone ADM, where there is no significant difference in deal durations between traditional and offshore suppliers.

EXHIBIT 5

Average deal duration across ITO offerings

Source: Everest Research Institute



Conclusions

- IT Outsourcing is a mature market, with the ADM and IO segments varying greatly in terms of growth dynamics and market trends.
- Traditional IO suppliers have mature offerings, as is borne out by their large buyer focus, signing long-term, multi-tower (bundled) contracts. RIMO suppliers have also evolved rapidly, and are moving from serving SMBs to making deeper inroads into large buyer accounts.
- ADM outsourcing is also entering a phase of relative maturity, with both traditional and offshore suppliers developing similar diversity in buyer industries and focusing on serving larger buyers. Traditional and offshore suppliers differ, however, in terms of deal sizes with large buyers and the adoption of sophisticated pricing mechanisms.
- Deal bundling across ITO and BPO functions is a marginal occurrence and does not result in significantly large outsourcing contracts. Bundling within ITO (i.e., IO-ADM) is by far the dominant trend in the market.

About the Everest Research Institute

Everest Research Institute (www.everestresearchinstitute.com) serves as a central source of independent and objective strategic intelligence, analysis, and actionable insight for leading corporations, service providers, technology providers and investors in the global outsourcing and offshoring marketplace. The Institute addresses both business process and information technology sourcing topics, providing the global outsourcing and offshoring community with information that empowers highly productive, sustainable sourcing strategies and relationships.

The Institute's distinguished Board of Advisors oversees the Institute's research agenda to ensure that it fully supports the business needs of the outsourcing and offshoring communities. Everest Research Institute clients receive access to unparalleled analytical and advisory services, including access to Everest analysts, detailed reports and whitepapers on outsourcing and offshoring topics, and webinars designed to provide insight and information about important market trends. The Institute's wealth of knowledge and experience provides clients with unique perspectives into today's marketplace and the competitive edge required to take advantage of emerging opportunities.

Everest Research Institute is the research arm of the Everest Group (www.everestgrp.com), a global consulting firm that assists corporations in developing and implementing leading-edge sourcing strategies. Since 1991, Everest Group has served as the trusted business advisor on hundreds of IT and business process outsourcing transactions worldwide.

For more information about Everest Research Institute, please contact:

Everest Research Institute
+1-214-451-3110
info@everestresearchinstitute.com

For more information about this topic please contact the author:

Shiraz Ritwik, Research Director
sritwik@everestgrp.com