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# The Issue: Taking a Reality Check on Today's Outsourcing Market

by Stan Lepeak, Managing Director — Research

By most conventional measures the information technology and business process outsourcing markets are thriving. Research organizations that perform market sizing work all estimate positive current and future outsourcing market growth, often at double digit levels. EquaTerra's own research finds that market growth levels remain solid. Nearly all major outsourcing service providers' revenues are growing, in some cases significantly. More important than growth levels to current and prospective buyers, however, is whether organizations are gaining the benefits sought from outsourcing. Here too, most findings are positive in terms of satisfaction, cost savings and process improvement. Yet, these buyers must be prepared to adjust for market dynamics in order to ensure success or risk becoming a statistic of an outsourcing failure. The media often limits its coverage to outsourcing terminations, work brought back in-house, and buyers "losing faith" in outsourcing. So how successful is the outsourcing market? What is the real story? This Perspective will address this critical point and do so empirically based on current and in-depth outsourcing market research.

The Details

There are many verifiable facts about the global information technology and business process outsourcing (ITO/BPO) market. It is a multi-hundred billion dollar market. It is a growing market in terms of the number and total volume of deals and the number and size of service providers serving the market. If through no other means, the magnitude of the outsourcing market and its growth levels are verifiable by reviewing the financial performance levels of the publicly traded service providers.

Whether or not outsourcing is "delivering on its promises" or users of outsourcing are satisfied is more difficult - though by no means impossible - to measure. Between the last quarter of 2004 and the first quarter 2007 EquaTerra has conducted eleven market studies that assessed buyers' outsourcing usage and satisfaction as well as their future outsourcing investment plans. One study that supports community observed trends is highlighted in Figure 1.

Figure 1: Outsourcing Satisfaction Levels

N = 310

1 = Very Unsatisfied, 5 = Very Satisfied
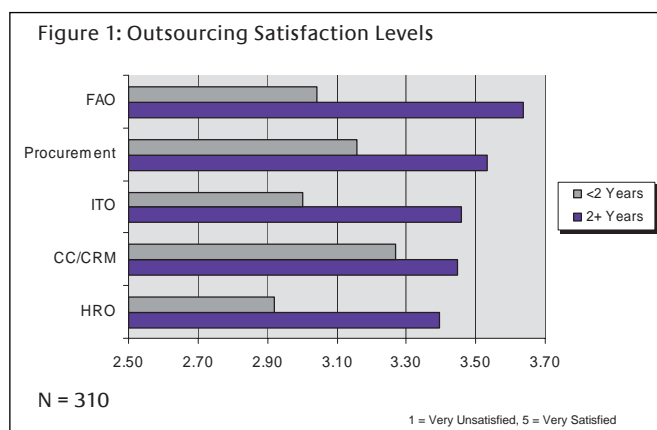
The market assessments primarily focused on buyers that had undertaken multiple process outsourcing and were of a minimum size of $100M revenue or 1,000 employees, though in most cases the studies focused on much larger organizations. Most studies also included only respondents that were director level or above and were involved in the outsourcing decision making process. During that same time frame EquaTerra also conducted 10 iterations of its quarterly EquaTerra BPO/ITO Pulse surveys. In short, the studies have been numerous, comprehensive, and targeted to respondents whose opinions matter most when it comes to assessing the outsourcing market.

Across all of these studies, buyer satisfaction with outsourcing remained positive, or above the norm (i.e., buyers were always more satisfied than dissatisfied), though there was room for improvement:

- A 2005 study of 200 BPO users found that 96 percent were moderately (55 percent) or highly satisfied (41 percent) with their efforts.

- The same study found that 73 percent of BPO users felt that efforts had enabled process improvement.

- A 2006 study of 289 ITO buyers found that 82 percent ranked themselves as being satisfied or very satisfied with their efforts.

- A 2006 study of 200 buyers across seven BPO categories found satisfaction levels ranging from 6.5 (call center/CRM) to 7.8 (R&D/pharma work) on a one to ten scale where one was not at all satisfied and ten was very satisfied.

- Two 2006 studies, one with 310 respondents and one with 113 respondents, assessed satisfaction levels in the following five functional outsourcing areas: IT, finance and accounting, human resources, procurement and call center. One on a one to five scale, with one being not at all satisfied and five being very satisfied, satisfaction levels ranged from 3.13 to 3.40. In the study of 113 outsourcing users, satisfaction levels with the outsourcing service providers employed averaged 3.48 on the same one to five scale.

- A critical 2007 study of multi-process HRO buyers assessed whether the benefits sought from outsourcing had been achieved. On a one to five scale, with one being benefits not at all achieved and five being benefits fully achieved, response levels ranged from 2.48 to 3.00.

There are differing opinions on the success in outsourcing. The topic has proven ripe for criticism among axe grinders, and those opinions aside, most business people view outsourcing as one of many tools available to improve performance and reduce costs, but only if it is pursued under the right circumstances and executed efficiently and effectively. This requires building an effective outsourcing governance organization and designing a relationship that delivers sustainable value. IT executives must continually and proactively validate their outsourcing decisions. These outsourcing buyers must evaluate their own situations, and this report is designed for those looking for the market perspective in broader outsourcing market trends and lessons learned.

In many cases with EquaTerra clients, the business case and organizational strategy will drive clients to conclude outsourcing functions are critical to success. Outsourcing remains a strategic tool among many of our clients. Yet, the internal requirements, technology and provider community provide a constantly changing environment that often requires modifying an outsourcing arrangement to properly adjust for these moving parts.
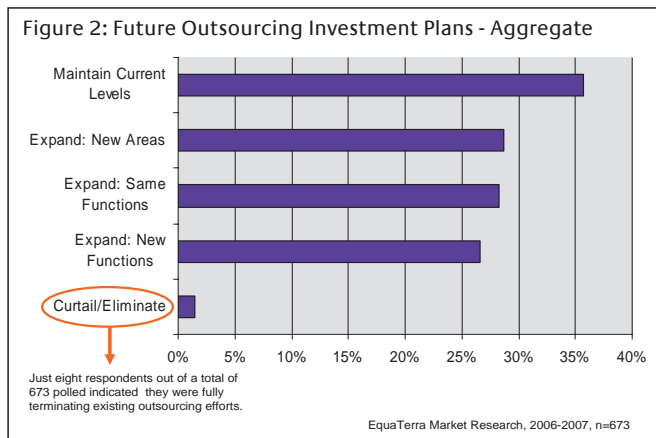
It is also just not EquaTerra research that finds that buyers are generally achieving the benefits sought from outsourcing. A market study of 226 commercial firm executives by PwC released in May 2007 found executives "bullish" on IT outsourcing. In this study, 87 percent of respondents indicated ITO delivered on the business benefits originally sought. Ninety-one percent of respondents planned to outsource again and felt ITO had become "an essential business practice." The findings do not imply ITO is easy to undertake or always the right solution for an IT problem but certainly it indicates that ITO has become a common and often beneficial tool for CIOs and their organizations to employ.

The last three EquaTerra studies referenced above, however, highlight that outsourcing satisfaction levels can improve, especially in HRO. That said, the levels are still positive and above average. It is also important to note that multi-process outsourcing, as addressed in these surveys, is still a relatively immature industry. In HRO, for example, EquaTerra estimates that there have globally only been 75-100 HRO deals involving five or more of the 22 HR processes. This is a small percentage of the potential buyers for HRO. In many respects these early adopters and their service providers are still learning what its takes to undertake outsourcing of this scale and scope successfully and hence are experiencing lower satisfaction levels.

Many of these larger and more complex deals have also occurred relatively recently. This is important because satisfaction levels in the early stages of deals, for example, is lower during the typical 12 to 24 month transition period than it would be in the steady-state or later in the deal (see Figure 1 from the EquaTerra 2006 market study, sample size 310). This is because transition is inevitably painful and buyers also often have unrealistic expectations about immediate outsourcing improvements. Buyers also often initially under-invest in outsourcing governance. Later into engagements buyers typically increase their governance investment which drives performance improvement often because buyers have a better understanding of what it takes to make outsourcing work well.

While the ITO market by most measures is more mature than other types of outsourcing addressed in these research efforts, ITO buyers and services providers are in a dynamic and rapidly changing market that tests their abilities to continually improve service quality. Hence, despite its maturity, the ITO market does not have markedly higher satisfaction levels. ITO has experienced the most "mega-deals" that are inherently challenging to deliver successfully. ITO is the most globalized general and administration outsourcing category and the service provider market is the most dynamic. ITO efforts also have to deal with a very rapidly changing IT hardware and software environment (e.g., the Internet, "e-business," ERP, Y2K, open source and other IT life events of the past 10 years). The terms of most ITO deals, for example, are longer than the lifecycle of the underlying technology.

Another means to test outsourcing satisfaction is to determine the future investment plans for current outsourcing users. Here EquaTerra also finds the message positive on outsourcing performance and bullish on its future. Across multiple market studies, EquaTerra assessed future ITO and BPO investment

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Figure 2: Future Outsourcing Investment Plans - Aggregate

Just eight respondents out of a total of 673 polled indicated they were fully terminating existing outsourcing efforts.

EquaTerra Market Research, 2006-2007, n=673

plans (see Figure 2). Approximately one third of buyers surveyed planned to maintain their current levels of outsourcing. Approximately 25 percent in each study planned to expand outsourcing's usage either in the same functional area currently outsourced or in new functional areas or in new geographies, divisions or business units. Less than two percent of respondents indicated that their organizations planned to curtail or eliminate their outsourcing efforts. Note that respondents in these studies could select more than one response, which is why totals exceed 100 percent.

In aggregate, therefore, current outsourcing buyers are much more likely to expand their outsourcing efforts rather than maintain current levels and rarely were they planning to fully bring work back in-house. This investment trend would seem to clearly indicate most buyers are satisfied with the return on their outsourcing investments.

The "curtail" or "eliminate" outsourcing response levels are much lower than the third party research cited in Figure 1. Setting aside potential issues with research quality on either side, there are some other potential causes for the extreme variations. One is that EquaTerra's market research studies focus on larger buyer organizations. As noted, respondents are typically from organizations with more than $100M in revenue and typically are from firms with $10B or more in revenue. Larger organizations with larger outsourcing investments are typically more experienced and more committed to their efforts. Similarly, EquaTerra research studies focus on deals with greater scope in terms of multi-process or multi-functional efforts often involving multiple geographies and business units. While efforts of this scale are more complex, they are also potentially more rewarding and buyers are more dedicated to driving their success.

What matters most is that buyers ensure that they understand the demographics of any market research effort when determining how applicable it is to compare to their own situation and effort. If a F100 outsourcing buyer is undertaking a global, multi-process HRO deal it is of little value to know that, for example, small cap buyers of modest offshore application development efforts often terminate their projects before the original completion date. Just as outsourcing success requires a business plan tailored to buyers' individual needs and situations, so too must comparative efforts to understand market trends and best practices. It is for this same reason that EquaTerra often takes issue with classic outsourcing performance benchmarking efforts; too often they are not comparing like situations or make extrapolations based on underlying, inaccurate or incomplete data. We will address issues with performance benchmarking in a future EquaTerra Perspective.

In contrast, several recent research studies do not present outsourcing as a viable approach (see Figure 3, next page). In an attempt to help current and prospective outsourcing buyers better understand the reality of current outsourcing market trends, this Perspective aggregates EquaTerra market research on ITO and BPO buyer satisfaction levels and future investment plans. These findings reinforce the EquaTerra position that, despite its problems, outsourcing has been proven as a viable business tool for enabling process improvement and cost reduction.

How are Outsourcing Buyers Responding?

It is clear from the EquaTerra market research that most outsourcing buyers are continuing to invest in and expand their outsourcing efforts. Buyers also are becoming more sophisticated in their efforts. This sophistication manifests itself in several ways:

- Buyers are more likely to pursue multi-sourcing efforts and spread work across multiple service providers and engagements. In some cases, often in HRO, this is a result of not being able to find a single service provider with the capacity and desire to take on a "mega-deal." More often, though, it is recognition of the potential benefits of multi-sourcing. These benefits are derived from using specialist service providers for certain functions and processes, deploying incrementally smaller but more manageable deals, diversifying risk, and taking advantage of a burgeoning market of qualified service providers. It is important for buyers to recognize and weigh, however, the increased cost and complexity of multi-sourcing both in the sourcing process as well as ongoing outsourcing governance.

• Buyers are more likely today to recognize that driving relentlessly towards the lowest cost deal can ultimately lead to disappointment. Being realistic about savings is about balancing process improvement with cost reduction as well as about recognizing the need to allow the service provider to earn an adequate profit for its efforts. Major service providers, often pressured to improve operating margins, are often less likely to pursue low or no profit deals. Both buyers and service provides are more experienced in calculating the true cost of current operations and estimating realistic savings opportunities that are possible from outsourcing. There is also greater practicality and maturity in outsourcing contracts, service levels and pricing models.

• Buyers today are typically better at addressing the inevitable challenges and problems that will arise over the life of major outsourcing deals. There are always unknowns that will arise that buyers must address as they engage in outsourcing. Tweaking service and price levels and in some cases changing the mix of what is outsourced is often necessary in outsourcing. The key is better managing these changes and not viewing them as a sign of failure or pending deal implosion.

• Buyers are investing more in outsourcing management and governance. This includes dedicating more senior and skilled staff to governance work, defining formal governance policies, processes and procedures, and investing in supporting governance software tools and applications. While there is an increased cost associated with these investments, buyers are finding that they must "spend money to save money" in major outsourcing efforts. That being said, buyers must ensure the quality of governance investments and not assume it is a case of more always equating to better.

How are Outsourcing Service Providers Responding?

Leading ITO and BPO service providers today are reacting to the outsourcing learnings that have occurred in the market over the past several years. They are improving their deal pursuit processes to better ensure they are not chasing after potentially bad or unprofitable deals or clients. Executive management at most firms have better insight into and involvement in the pursuit of major deals. Leading providers are also better managing their pursuit costs and focusing on the most appealing opportunities.

Figure 3 – The Outsourcing Sky is Falling……
There will always be flawed or failed outsourcing deals, just as with any other major organizational change effort, like ERP software implementations or mergers and acquisitions. The key question is how much are they the exception or the rule and are they the result of flawed execution or flaws in the outsourcing concept. An observer of the mainstream or IT services trade media might tend to feel flaws and failure are more common as these results are most often quoted in the headlines.

The Headlines	Key Points/Questions
1. Outsourcing, particularly offshore, is a "destructive business practice… and killing an American job and putting it in the hands of someone making one-tenth as much." Source: Lou Dobbs.	Most outsourcing occurs locally. More jobs are lost to automation than outsourcing.
2. "70 percent of employers reported negative experiences with outsourcing…44 percent failed to see cost savings materializing as a result of outsourcing." Deloitte, 2005.	Is a study sample of 25 outsourcing buyers sufficiently large enough from which to draw relevant conclusions?
3. "The number of buyers prematurely ending an outsourcing relationship has doubled to 51 percent." DiamondCluster, 2005.	What constituted a "relationship" or "deal" in this study? Terminating a small project using some offshore labor for ADM work is different that prematurely ending a major ITO or BPO effort (a rare event).
4."65 percent of outsourcing contracts terminated before the actual date of termination over the past two years…Two thirds of outsourcing contracts worth more than £20m are 'unravelling' before the end of their contract terms." Compass, 2007 .	What's the profile of these contracts? Were the fully terminated or were just certain pieces of work brought in-house? What's "unraveling" mean anyhow?

The ITO market has been reinvented by the extensive use of remote, lower cost resources. India-based service providers have excelled through this model but multinational ITO providers are rapidly expanding their own lower cost market footprint. Both groups are expanding rapidly to emerging service delivery locations like the Philippines, Central and South America, Eastern and Central Europe, Russia, and China. While the initial focus was on lower delivery costs via labor arbitrage, the emphasis now is on exploiting the use of highly skilled resources and creating truly global service delivery models. Global ITO also had moved beyond application development and maintenance to support commercial packaged application services and most recently infrastructure and operations services. So while the ITO service provider market is most mature in the general and administration space, it is still very dynamic and rapidly changing.

Major BPO service providers, particularly in the HRO space, are still often struggling with capacity issues. This is in part of a function of operating in a maturing market and highlights the complex nature of deals that are being constructed. All BPO service providers need to better sell and deliver more standardized service offerings, emphasizing the value of successfully delivering a service over the appeal of a more complex and unique service that may prove more difficult to successfully deliver profitably.

While multinational service providers' continued expansion into lower cost markets will help their margins, it also gives them access to additional talent to address capacity constraint issues. Western expansion by India-based service providers is helping to support their efforts to move from the ITO space into the BPO space, an effort most are succeeding at though still on a small scale. Multinationals, however, need to continue to work to improve their remote delivery capabilities while providers from lower cost markets must continue to successfully manage rapid growth levels and continue to build out their specific business process and vertical industry capabilities.

The Advisor Perspective – Critical Points to Consider

Buyers of outsourcing services need to determine if, when and where BPO and ITO are suitable business tools to deploy in their organizations and understand how these relationships are likely to change over time. Keen focus is not only required on building the outsourcing business case but also on ensuring the skills, resources and commitment exists to successfully execute on and then manage and govern the outsourcing effort. Critical to outsourcing success for buyers is to understand what has and has not worked for their peers. While every outsourcing effort is unique, buyers can learn much from the experiences of their predecessors. This is why it is important for buyers to track and monitor success levels for outsourcing in the market as well as monitor the nature of future investment plans. Buyers must use caution, however, and ensure that any market assessments they are reviewing are accurate and applicable to their own circumstances.

Recognizing that while outsourcing satisfaction levels are positive and the market continues to grow, buyers should still identify typical problem areas in outsourcing and proactively address them. Here are some common pitfalls that buyers should strive to avoid:

- Outsourcing decision criteria and their relative importance are poorly defined: If outsourcing goals are not clearly defined, it is difficult to determine if they are ever met.

- Shortcuts are taken to expedite the deal: Buyers must take the time and seek the advice and expertise needed to build a business plan and identify and negotiate with the appropriate service provider as well as plan for the transition and governance work. Rushing the outsourcing courtship can lead to a troubled marriage.

- The choice of the commercial model is disconnected from change drivers: Contractual obligations, service levels and pricing should drive the service provider towards the desired outsourcing goals. For example, maximizing cost reductions typically does not mix well with improving service levels.

- The governance and retained organizations are poorly designed and implemented: Buyers must begin to plan early for the outsourcing transition and subsequent governance efforts. Adequately staffing the retained and governance organizations and deploying solid policies, processes and procedures are critical to outsourcing success.

- Unrealistic or poorly communicated expectations about what changes will occur when outsourcing occurs: Buyers must focus on change management and better manage both user and executives' expectations. Things are typically worse, not better, during the early stages of an outsourcing effort and buyers must prepare for this likelihood.

- The focus is on first and second years' savings rather than on balancing short- and long-term benefits: While quick hits are important, buyers must view the outsourcing process as a journey and not as an event.

- Buyer and service providers are unable to manage change: Because outsourcing is a journey, many unexpected events will occur. Processes, trust, open communications, and executive-level involvement and support on both sides are critical to managing this change.

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Conclusion

Despite some market rumors to the contrary, EquaTerra market experiences and research find that the information technology and business process outsourcing markets are delivering much of the value and benefits sought by its users. It is growing and will continue to grow and diversify going forward. Many buyers, however, experience problems – some small and some large – with their outsourcing efforts. This is typically a function of mis-set expectations, inadequate skilled resources, or service provider shortcomings. Poor execution, however, is not an indictment of the outsourcing concept. Current and future outsourcing buyers must focus intently on avoiding past mistakes they and their peers have made. Outsourcing has become a commonplace and valuable business tool so buyers need to understand where, how and when – and when not – to employ it successfully.

About EquaTerra

EquaTerra sourcing advisors help clients achieve sustainable value in their IT and business processes. With an average of more than 20 years of experience in over 600 global transformation and outsourcing projects, our advisors offer unmatched industry expertise. EquaTerra has in-depth functional knowledge in Finance and Accounting, HR, IT, Procurement and other critical business processes with advisors throughout North America, Europe and Asia Pacific. Our people are passionate about providing objective, conflict-free advice to our clients, which has fueled our exponential growth over the past three years. We help clients achieve significant cost savings and process improvements with outsourcing, internal transformation and shared services solutions. **It is all we do.**

If you have questions about this report or would like to learn more about how EquaTerra can help your organization address the points and opportunities discussed, please contact Stan Lepeak at Stan.Lepeak@EquaTerra.com or +1 203 458 0677.

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