IT Outsourcing in the Small and Medium Businesses –

There is a Light at the End of the Tunnel

By Ross Tisnovsky, Vice President
Everest Research Institute

AN EVEREST RESEARCH INSTITUTE WHITEPAPER

EVEREST
RESEARCH INSTITUTE

Entrepreneurship

Entrepreneurship is the last refuge of the trouble-making individual.

Mason Cooley (1927-2002)

Executive Summary

Small and Medium Businesses (SMBs) have unique IT needs, stemming from low IT budgets and small project sizes in Application Development and Maintenance (ADM) outsourcing, lack of scale in operations, and reliance on business power users of IT in Infrastructure Outsourcing (IO).

These characteristics have profound implications for outsourcing suppliers that decide to focus on serving SMBs. Suppliers increasingly realize that:

- ADM processes that worked well for them with large companies often do not work with SMBs

- Sufficient scale in IO operations is difficult to achieve

- Smaller revenues per client make it difficult to offset the high cost of sales to SMBs

As a result, few outsourcing companies have made SMBs their target segment.

Nonetheless, the SMB market is a fundamentally healthy market in terms of growth and size. SMBs spend more on IT as a share of revenue than large enterprises; hence, they have an even higher incentive to cut IT costs.

Several factors will likely increase penetration of outsourcing in the SMB market. Among others, examples include advances in remote-management tools and increased interest from offshore suppliers.

Successful ADM and IO suppliers employ similar approaches in serving the SMB segment. The key components are standardization of offerings, personalization of service, and low sales overhead.

This paper discusses:

- Unique outsourcing needs of SMB clients

- Outsourcing opportunities in the SMB market

- Emerging business models to serve SMBs

IT Outsourcing Needs of SMBs

Deploying CMM 5-quality processes with massive documentation requirements is not plausible with resource-constrained SMBs

SMB companies' outsourcing needs vary significantly from those of large enterprises due to the unique challenges facing SMBs.

In Application Development & Maintenance (ADM), SMBs encounter significant management resource challenges arising from smaller IT budgets, limited scale of the development projects, and the buyers' requirements for a high-touch approach. Challenges include:

- **Low IT budgets.** Low budgets do not allow hiring appropriately skilled resources for supplier management and engagement governance. These roles often end up being fulfilled by existing IT resources with technical rather than business skills.

- **Small project scale.** The smaller scale often requires a very fast start-up and does not allow comprehensive knowledge transfer to the supplier, forcing the supplier's resources to learn on the fly.

- **Increased time to market.** The concerns around increased time to market often result in SMBs deploying a Rapid Application Development[1] (RAD) approach, leading to inadequate specifications, undocumented business requirements, and a need to "cut through delivery stack" (i.e., communicate directly with the supplier's developers).

This situation creates a unique challenge for suppliers. Deploying Capability Maturity Model (CMM) processes with massive documentation requirements is not plausible under these circumstances. This situation has to be remedied through extensive collaboration with business users and a direct link to developers; but such collaboration is challenging when developers are located remotely, often with a significant time-zone difference.

Infrastructure Outsourcing (IO) presents its own set of challenges, which are rooted primarily in the small scale of IT operations. These include:

- IT infrastructure-management and support resources are often embedded in business and therefore not easily identifiable (i.e., "Shadow IT"[2] costs). Even when identified, these resources often have other responsibilities, which make it impossible to realize the savings attributable to outsourcing.

- An abundance of IT power users (i.e., business users who "learned" IT management over time) make it difficult to establish discipline in the use of IT assets and creates

1 RAD is the approach to application development that results in an increased speed of development, through active involvement of the end users in the analysis and design stages.

2 "Shadow IT" costs is the term often used in reference to IT resources who are accounted for in business rather than IT budgets, artificially decreasing a company's IT expenditure.

stick to the processes and rules that they have developed over time.

- Finally, suppliers face a situation in which the small IT operations of SMB clients do not leave any space for account management overhead and make it very hard to achieve overall scale of the operations, which is a critical lever in infrastructure outsourcing engagements.

As a result of these factors:

- Large traditional outsourcing companies that possess the right scale and capacity find that their existing account-management model does not allow them to serve SMBs, due to the high cost of the account-management overhead.

- Smaller outsourcing companies usually have leaner relationship-management models, but lack scale to achieve favorable economics that would offset the high costs of sales to SMB clients.

Finally, a significant fragmentation of the SMB market and a higher rate of bankruptcies among SMB companies (see Exhibit 1) complicate the sales effort and result in further increased sales costs.

EXHIBIT 1

Business bankruptcy filings in the US (thousands)

Source: American Bankruptcy Institute, 2006
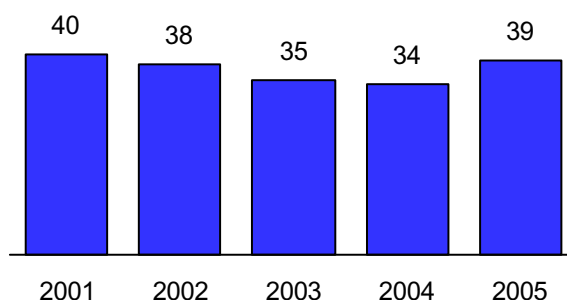
These unique challenges lead to few mainstream outsourcing companies publicly declaring a focus on SMB outsourcing and truly committing to serving SMB clients. In large part, sub-scale companies with primarily offshore operations serve SMBs.

Several attempts of traditional outsourcing companies to serve the SMB market have failed or led to worse results than planned. Most notably, these include:

- EDS entered into an alliance with BellSouth in 1998 to offer Web hosting services to SMBs. The offering did not gain broad acceptance and the alliance was closed in just three years.

- IBM tried several initiatives to upsell managed services to SMBs through its extensive business-partners network. This seemingly logical value proposition—of lower sales cost through resellers, coupled with the supplier's high scale—consistently under-delivered over many years. Only ~5% of IBM's service revenues go through channels today (compared to ~60% of hardware and software).

The SMB Market Conundrum

The SMB segment is fundamentally healthy and attractive,
but outsourcing suppliers face multiple challenges

Industry analysts usually define the SMB market to include companies with fewer than 1,000 employees. According to government statistics, the US alone has almost eight million of such companies.

The SMB market exhibits a much greater annual growth in IT expenditures than the more mature enterprise IT market. The SMB market rebounded from a significant drop to 2-3% annualized growth in the after-boom years of 2001-2002 to approximately 7-8% worldwide, according to Gartner[3]. This is a very respectable growth compared to the enterprise IT expenditure growth of 3-5% annually.

Further, SMBs in almost every industry tend to spend more on IT as a percentage of their revenues than their larger counterparts (see Exhibit 2.)

E X H I B I T   2

Comparison of IT spending as a percentage of company revenue

Source: Forrester Research, 2004

Legend: Large Enterprises, SMB enterprises

Industry	Large Enterprises	SMB enterprises
Utilities & Telecom	2	2.1
Media & Entertainment	2.5	3.3
Business Services	3.3	3.7
Retail & Wholesale	1.6	1.8
Manufacturing	2.2	2.4
Finance	6.7	7.7
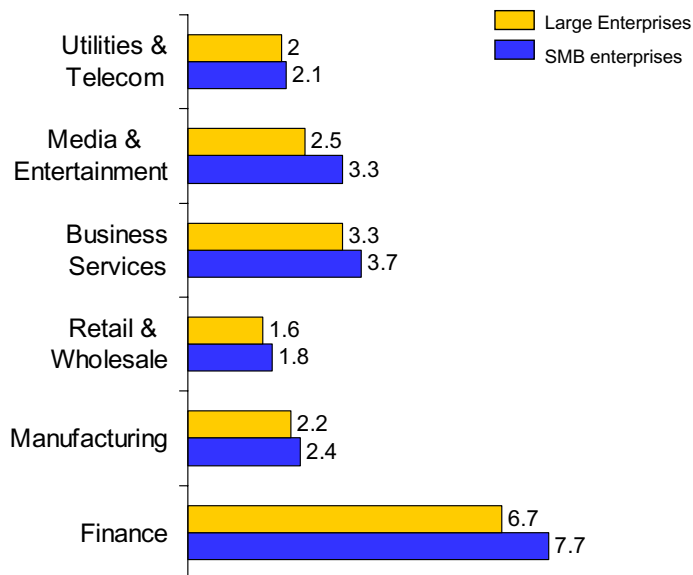
This trend suggests that SMBs should have an even greater appetite for IT savings, creating a powerful basis for demand for outsourcing services. Further, the IT outsourcing market is becoming more SMB friendly in nature, which is evident from the decline in the size of outsourcing transactions and shorter contract timeframes (see Exhibit 3).
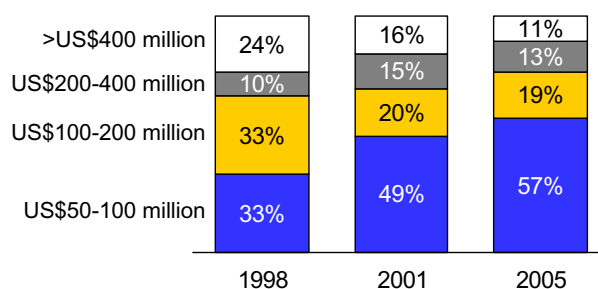
3 Gartner Research (2005)
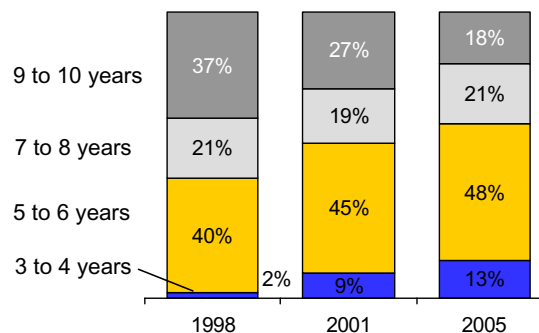
E X H I B I T   3

Decline in size and timeframes
of outsourcing contracts

Source: Evereest Research Institute 2006
Based on a sample of 2000 transactions in the Everest database; includes ADM and IO

Number of outsourcing deals within TVC range

	1998	2001	2005
>US$400 million	24%	16%	11%
US$200-400 million	10%	15%	13%
US$100-200 million	33%	20%	19%
US$50-100 million	33%	49%	57%

Number of outsourcing deals within contract length range

	1998	2001	2005
9 to 10 years	37%	27%	18%
7 to 8 years	21%	19%	21%
5 to 6 years	40%	45%	48%
3 to 4 years		9%	13%
	2%		

Nonetheless, SMBs were very late to the outsourcing market and even today rank out-
sourcing last in their assessment of IT priorities, according to a recent Forrester Research
survey[4]. The majority of SMBs participating in the survey stated outsourcing was behind
other IT priorities such as PC upgrades, security improvements, and new packaged
application deployment.

4 Forrester Research "Top IT Priorities For Medium-Size Businesses In 2005"

ERI.2006.4.W.0136

Emerging Approaches to Serving the SMB Market

Several factors suggest that the SMB segment is unlikely to remain below the radar of ITO suppliers for long and will play a much larger role going forward. These factors include:

- Advances in the remote-management tools are leading to the ability to serve an increased number of functions remotely and the ability to take advantage of the Software-as-a-Service (SaaS) model in deploying these tools.

- Virtualization technologies are gaining acceptance and allowing better scale play in distributed systems, which are a primary technology platform for SMBs.

- Relative rebound in the start-up activity and influx of venture-capital money into the software industry is likely to prompt creation of a large number of SMBs with extensive software development needs.

- Offshore outsourcing firms that historically preferred to focus on large companies to fuel their ~30% yearly growth will have to actively look for new sources of revenue and will likely pay increased attention to SMBs.

Along with more obvious ADM projects, a typical SMB can outsource a variety of Infrastructure Managed Services. SMBs prefer to engage in selective outsourcing rather than transferring complete tower(s) to a supplier. Most frequently, SMBs show interest in:

- Managed desktop

- Managed security (e.g., e-mail security, firewall, anti-virus)

- Disaster recovery

- Managed hosting services

- Managed VPN services

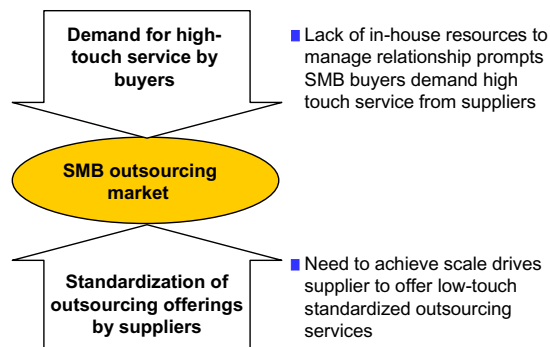Two conflicting forces are shaping emerging offerings in the SMB space (see Exhibit 4):

1. A desire for high-touch service, stemming from low IT sophistication of a buyer's internal resources and lack of resources to manage supplier relationships

2. A push from suppliers toward more standard, productized outsourcing offerings (e.g., managed e-mail back-up) to compensate for lack of scale in a buyer's operations

> Several market factors suggest that the SMB segment is unlikely to remain below the radar of ITO suppliers for long

EXHIBIT 4

Conflicting forces in SMB outsourcing market

Source: Everest Research Institute analysis

Demand for high-touch service by buyers

■ Lack of in-house resources to manage relationship prompts SMB buyers demand high touch service from suppliers

SMB outsourcing market

Standardization of outsourcing offerings by suppliers

■ Need to achieve scale drives supplier to offer low-touch standardized outsourcing services

The SMB market tends to be underserved; it is difficult for suppliers serving large enterprises to meet the SMB needs. However, there may be latent opportunity available for suppliers who want to enter this market. To illustrate this point, we examined the financials of Infocrossing, one of few suppliers who is both focused on this segment and is publicly traded (therefore providing financial reporting information relevant to the SMB segment). Infocrossing is achieving positive economics servicing SMBs, indicating that while it may require changes to current operations, other suppliers could achieve similar returns.
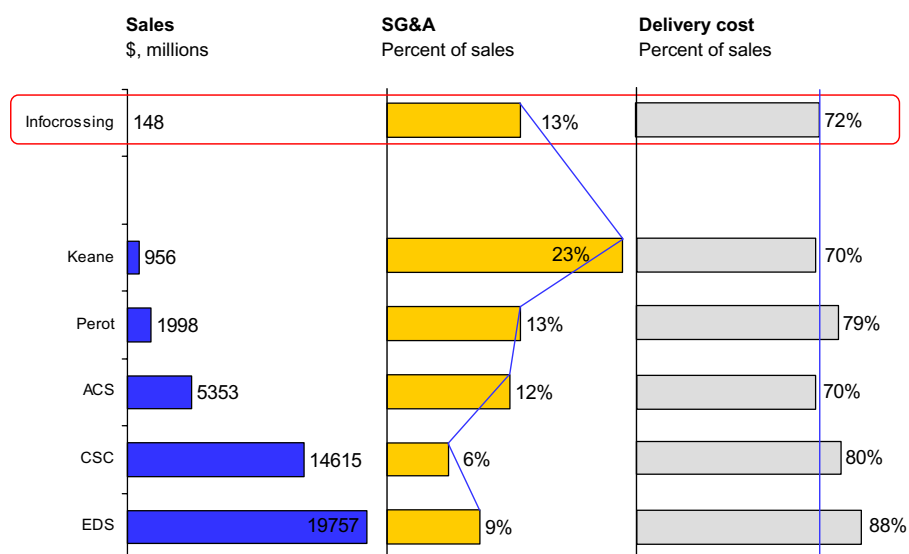
What are the keys to success when servicing the SMB market? There seem to be three critical pieces to the puzzle:

- **Sell in a cost-effective way.** Some suppliers achieve cost effectiveness by engaging hardware distributors as a channel; some go the software route by partnering with application vendors to jointly offer SaaS; and others manage to achieve it with a direct-sales force. Regardless of the selling strategy, the SG&A (selling, general, and administrative expense) of such companies as a percentage of revenue tends to be much smaller than their enterprise-focused peers. (See Exhibit 5 for an illustration of SMB-focused-Infocrossing versus other outsourcing suppliers.)

- **Achieve scale in operations.** Despite serving smaller companies, a supplier must develop a delivery cost comparable to those of larger outsourcing firms focused on serving enterprise clients (see Exhibit 5). Standardized offerings are the primary lever in achieving this scale (e.g., managed services in IO)

- **Deliver against SMBs' high-touch expectations with minimal relationship overhead.** This involves establishing a relationship model that minimizes documentation overhead and actively involves developers in client interactions.

EXHIBIT 5

Comparison of operational
performance of select
outsourcing companies

Source: Everest Research Institute analysis

	Sales $, millions	**SG&A** Percent of sales	**Delivery cost** Percent of sales
Infocrossing	148	13%	72%
Keane	956	23%	70%
Perot	1998	13%	79%
ACS	5353	12%	70%
CSC	14615	6%	80%
EDS	19757	9%	88%

ERI.2006.4.W.0136

Recommendations

The SMB market is a healthy outsourcing market that presents significant opportunity for those suppliers that figure out how to serve it. SMB clients might prove to become the missing piece in the puzzle of the next source of growth in outsourcing.

Outsourcing suppliers that want to play in the SMB market need to develop several critical capabilities. These include:

- **Deploy a cost-effective sales model to serve the SMB market.** Leveraging channels (e.g., distributors) is not a universal approach; it tends to work for smaller suppliers but remains a challenge for the large ones.

- **Develop a relationship-management model that does not overload the project but delivers enough personal touch for the customer.** In particular, ADM projects will need to "cut through the delivery stack" to allow direct client communication with the suppliers' resources.

- **Standardize the offerings.** Standardization is especially important for Infrastructure Outsourcing, where the basic rule of "no scale – no savings" holds true for SMB-focused suppliers.

- **Prioritize prospects ruthlessly**. Not all SMBs are the same. Do not go after those with low sophistication or dubious business prospects. Do not limit due diligence to the IT organization; look at the financials and business growth.

About the Everest Research Institute

Everest Research Institute (www.everestresearchinstitute.com) serves as a central source of strategic intelligence, analysis, and actionable insight for corporate buyers, service providers, and investors in the global business process outsourcing and information technology outsourcing marketplace. The Institute is dedicated to providing the global outsourcing community with the information it needs to build highly productive outsourcing relationships and programs, focusing on the drivers that are continually reshaping the industry landscape and analyzing how they impact member organizations and the success of their outsourcing strategies. The Institute's distinguished Board of Advisors, all senior executives and thought leaders in global outsourcing, oversee the Institute's research agenda to ensure that it fully supports the business information needs of corporate buyers, service providers, and investors.

Everest Research Institute members gain unique and highly personalized analytical and advisory services, not available elsewhere, including:

- **Unlimited analyst access** – In addition to a full-day strategic planning session for in-depth, face-to-face discussions, Everest analysts are available for ongoing consultation to address members' immediate issues and concerns. Such access is unprecedented in the industry, and gives members a distinct competitive advantage as they seek to take advantage of emerging opportunities, changing market conditions, and unforeseen developments.

- **Visionary research with actionable insight** – Members receive in-depth reports on major outsourcing topics, supplemented by quarterly updates and monthly research notes on market-shaping events, including regulatory developments, technological advancements, and emerging sources of risk and value. These forward-looking reports not only cover important trends and developments, but also project future scenarios and outcomes of outsourcing decisions made today. This comprehensive interpretation of data provides members with actionable insights to support decision-making.

- **Wealth of knowledge and experience** – Members benefit from the domain expertise and perspectives that come from Everest's direct involvement in structuring and negotiating more than 530 ITO and BPO transactions and more than 800 best practice case studies. Everest analysts have intimate knowledge of the strengths and weaknesses of service providers in different markets, processes, industries, and geographies. They also have a first-hand understanding of how buyers approach the vendor selection process and, ultimately, of the factors essential to outsourcing success. In addition, the Institute has tapped multiple market sources and collected proprietary information to assemble the industry's most comprehensive database.

EVEREST RESEARCH INSTITUTE *was established by the Everest Group, which provides strategic advisory services that help companies harness the power of outsourcing. Since its formation in 1991, Everest Group has served as business advisors for hundreds of IT and business process outsourcing transactions worldwide.*

For More Information
Contact the author

Ross Tisnovsky, Vice President
Everest Research Research

Email: rtisnovsky@everestgrp.com

EVEREST
RESEARCH INSTITUTE