

2008 Spending on IT Services – New Paradigm, or Continuous Denial?

Investigation of the Likely Impact of the Economic Slowdown on IT Services Spending

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Executive Summary

The world of IT services is witnessing a move towards cost optimization. In the wake of such a scenario, questions about the extent of a slowdown in IT services spending that might be experienced in 2008 are currently dominating the thinking of IT service industry participants. The impact of a potential economic slowdown is, therefore, the key subject of investigation. This whitepaper aims to look at what could be the likely fallouts in ITO of buyer decisions under certain economic conditions during 2008.

The effect of upcoming cost optimization efforts on IT services spending will vary dramatically, based on a few factors such as the mode of service delivery and cost-cutting lever the supplier utilizes. The IT services, namely IT consulting, Application Development & Maintenance (ADM) outsourcing, and Infrastructure Outsourcing (IO) will react differently under the influence of the above factors.

Infrastructure outsourcing is generally a “non-discretionary” service (often under a long-term contract) that is prone to prove resilient, even in an economic downturn. Most infrastructure services cannot possibly be switched off due to business criticality. Therefore it is less likely to be adversely impacted by an economic downturn.

Cost-cutting in ADM and IT consulting is likely to have a negative effect, the extent of which will differ depending on the dynamics of the two services.

However, offshoring is the big wild card in understanding the effect of an economic slowdown on ADM and IT consulting and gives rise to conflicting situations. On the one hand, offshore services are relatively easy to cut and do not affect employee morale as much as layoff of internal staff. On the other hand, offshoring is one of the most effective savings levers; thus economic challenges might even speed up the adoption of offshoring.

A strong voice has been lent to a moderate move towards offshoring by the IT services community. According to a recent survey jointly conducted by Bernstein Research and Everest Research Institute, if the business environment of IT services customers were to substantially weaken, most individuals believe that there will be a slowdown in onshore budgets and the buyers will look to move work offshore.

This paper discusses:

- The service industry taxonomy and the contrasting dynamics of constituent segments
- The behavior of the different IT service segments under certain economic conditions and the factors that govern such changes

IT Services Industry Overview

Project-based spending shows resilience in the initial stages of cost-cutting but can drop meaningfully in a sustained business downturn, typically lagging the economy

The IT services sourcing industry consists primarily of three categories – consulting, outsourcing, and product maintenance. **Exhibit 1** expands and maps the service offerings within IT along these categories. IT services differ fundamentally in the type of service offered. Additionally, service offerings are also distinct in terms of how business views the models of service delivery. For purposes of this whitepaper, we align the functions inside IT services along two main classes:

- Project-based work
- Activity-based service

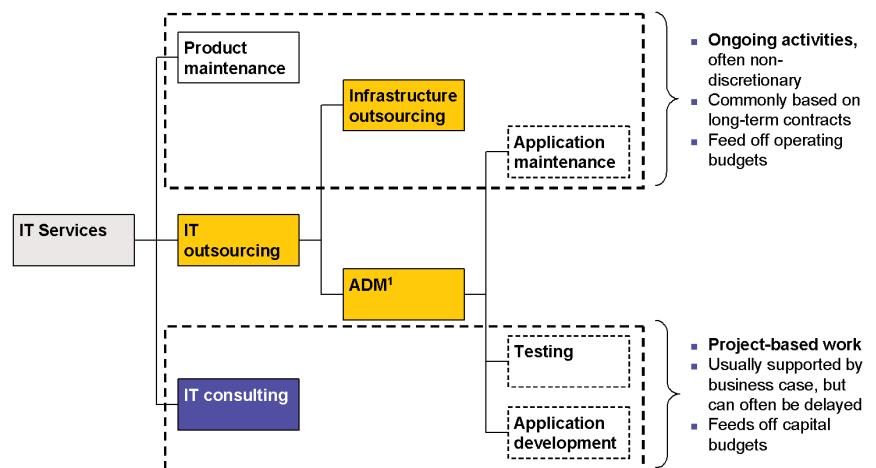
Efforts modeled along the lines of a project with well-defined end objectives and durations are termed project-based work. They typically add value to an existing system, or entirely new systems are developed through such efforts. Therefore it is inherent in the nature of project-based work that it be more strategic and more often supported by the business case. Such projects tend to feed off capital budgets.

Certain IT efforts are driven by the need to run the day-to-day business and are a critical functioning element of the backbone of business. They are more procedural and non-discretionary in nature and are typically on-going, requiring long-term commitment. We term them activity-based work.

EXHIBIT 1

Service industry taxonomy

Sources: Bernstein Research, Everest Research Institute



1 ADM – application development and maintenance

Business views the categories with contrasting underlying dynamics differently.

Due to their nature of operations, product, and application maintenance along with infrastructure outsourcing tend to be ongoing activity-based longer-term contracts that form a critical part of the IT environment of the organization. Hence it is challenging to restrict or discontinue investments in such activities.

Application development, testing, and IT consulting are project-oriented with a clear business goal and timeframe. Investments in such projects tend to be aligned to the health of the business and are prone to financial restrictions during challenging phases.

Project-based work tends to be resilient in the beginning phases of an economic cost-cutting, but can be prone to over-reaction if recession persists. Effect of cost-cutting on project-based services depends on the extent of the strain on the business environment.

Exhibit 2 shows a micro-economic picture of a typical company and its reaction to the recession.

Assuming a situation when a certain company investing in application development projects goes through a period of downturn with declining profit, the investments in the project initially continue unrestricted through a “denial phase.”

When profits fall further, the IT department is mandated to cut costs and turn down new investments in fresh ventures. However, existing projects continue to roll through this phase.

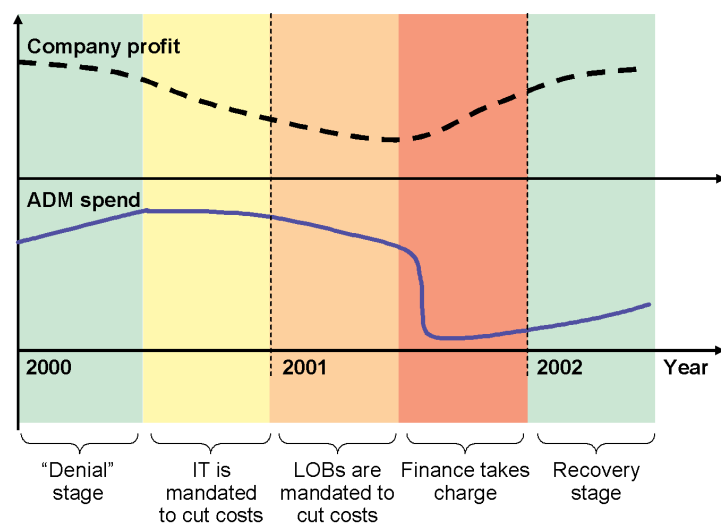
With continuing downturn beyond this point, the lines of business are mandated to cut their IT development demands, thereby impacting ongoing investments in projects.

The purse strings are tightened further by corporate finance in order to control cost; subsequently, project investments see a sharp fall with telling positive effects on margins. Investments increase as and when the company recovers from the cost-cutting phase.

EXHIBIT 2

Micro-economic view of IT cost-cutting dynamics

Sources: Bernstein Research, Everest Research Institute

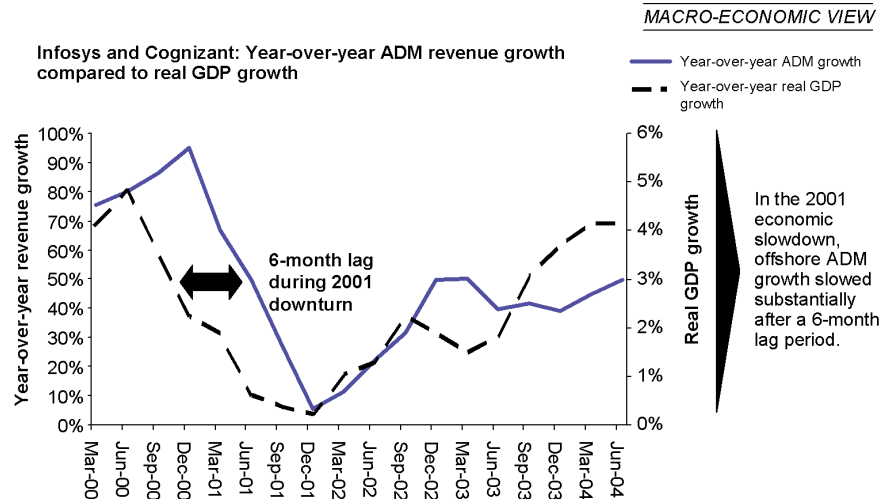


These dynamics of IT cost-cutting aggregate to similar behavior in the macro-economic scene (see **Exhibit 3**). For example, the ADM segment of ITO has shown high sensitivity to the U.S. economy during the 2001 downturn. The ADM revenue growth also had a six-month lag with the GDP growth curve. Similar high sensitivity and the lag has also been demonstrated by the growth of consulting/system integration segments to GDP growth in the United States.

EXHIBIT 3

Sensitivity of ADM segment to U.S. economy

Sources: Corporate reports, Bureau of Economic Analysis (BEA), Bernstein estimates and analysis, Everest Research Institute



Infrastructure Outsourcing and the Impact of an Economic Slowdown

Infrastructure outsourcing is generally a “non-discretionary” service and cannot possibly be switched off due to business criticality. Majority of the cost-cutting in infrastructure budgets happen through IT infrastructure consulting

Infrastructure services are generally long-term contracts having pre-determined service levels. The primary objective is to make the information infrastructure backbone predictable and transparent to business. These services are generally “non-discretionary” and are prone to prove resilient during an economic downturn. Infrastructure is critical to the daily operations of the business and has to be in the “always-on” mode.

Three major factors contribute to the immunity to cost-cutting measures enjoyed by infrastructure services. These factors are:

1. **Cost-cutting is a challenge** – Business leaders are unsure of the criticality of IT infrastructure due to lack of a business-impact view of infrastructure outsourcing, making it difficult for them to push for cost-cutting.
2. **Infrastructure outsourcing involves initial savings** – There are very few sources of immediate savings in infrastructure (except for purchased spend); and long-term efforts are often cash negative in the first year, which makes them fundamentally unattractive.
3. **Low-hanging fruit is scary to touch** – End-user computing is the most prone to savings, but the effect of cost-cutting in this area hits where it is most painful (e.g., quality of desktop support, problem resolution), which is usually bad for employee morale.

Most infrastructure services cannot be switched off, due to their business criticality (e.g., a logistics business needs maximum reliability from its database servers and will only cut utilization or asset refresh to address business downsizing needs).

Infrastructure consulting also proves resilient to cost-cutting. Consulting efforts are well suited to repurposing as required by the changing needs of business. Through a combination of various cutting-edge automation tools and efficiency improvement, infrastructure consulting can be quickly re-tuned to deliver new business goals (e.g., reduce the need to cut down on actual utilization of infrastructure).

Buyers have used multiple cost-saving levers in IT outsourcing, with most requiring consulting effort (see **Exhibit 4**). Depending on the business need, a buyer may need to optimize asset acquisition or better utilize assets. In the former situation, the buyer can renegotiate contracts, adopt strategic sourcing or make changes to its existing supply chain. All three strategies can provide cost-cutting without impacting service/usage.

EXHIBIT 4

Cost-saving levers in IT infrastructure

Sources: Bernstein Research, Everest Research Institute

	Description	Realization approach	ILLUSTRATIVE
Acquire assets	Renegotiate contracts ■ Buy assets and services cheaper	In-house/ consulting	<ul style="list-style-type: none"> Cost cutting is not necessarily bad news for infrastructure services While some incumbent suppliers might encounter contract renegotiations, most of the work ends up outsourced or done by consultants
	Adopt strategic sourcing ■ Use leverage of an aggregator, implement spend management best practices services	Outsource	
	Reinvent supply chain ■ Buy assets only when needed and only as much as needed	In-house	
Utilize assets	Manage demand ■ Reduce IT effort by managing IT asset/service consumption	In-house/ consulting	
	Manage to best practices ■ Reduce effort through use of advanced management techniques	Consulting	
	Re-architect assets ■ Decrease complexity; Increase automation	Consulting/ outsourcing	
	Consolidate assets ■ Reduce number of assets supported/managed	In-house/ consulting	
	Capture labor arbitrage ■ Use less expensive resources	Outsourcing	

The majority of the cost-cutting in IT infrastructure, therefore, requires technical expertise and is likely to involve IT consulting. Hence, cost-cutting does not necessarily spell trouble for IT infrastructure services. Some incumbent suppliers may have to deal with contract renegotiations, but most of the work is done by consultants or is outsourced.

The most common cost-saving lever often used by buyers of infrastructure services is cutting purchased spend (e.g., lengthening the technology refresh cycle). Although it has the tendency to impact hardware/software spending, it seldom affects purchased IT services.

ADM and IT Consulting

Cost-cutting is generally bad news for ADM and consulting, as they are more project-based in nature and most of the cost-cutting is achieved through limiting demand of these services

Application Development (AD) and consulting tend to be project-based and discretionary in nature in contrast to IT infrastructure; thus, unlike infrastructure services, AD and consulting are more dispensable during downturns. Application maintenance nonetheless is relatively stable. Maintenance work is not suitable for scope reduction, as it is critical for upkeep of existing business applications.

Cost-cutting in ADM is likely to have a significant overall negative effect on the sourced ADM services, as most cost improvements in ADM come from limiting demand for ADM (e.g., cancelling development projects, reducing maintenance efforts). ADM projects often require near-term investments to drive long-term benefits and can be cut in times of business strain. Nonetheless, there is an emotional attachment to ADM projects for lines of business, as ADM is driven by business and provides direct business benefits. This is a primary driver of the “denial stage” in ADM cost-cutting discussed above.

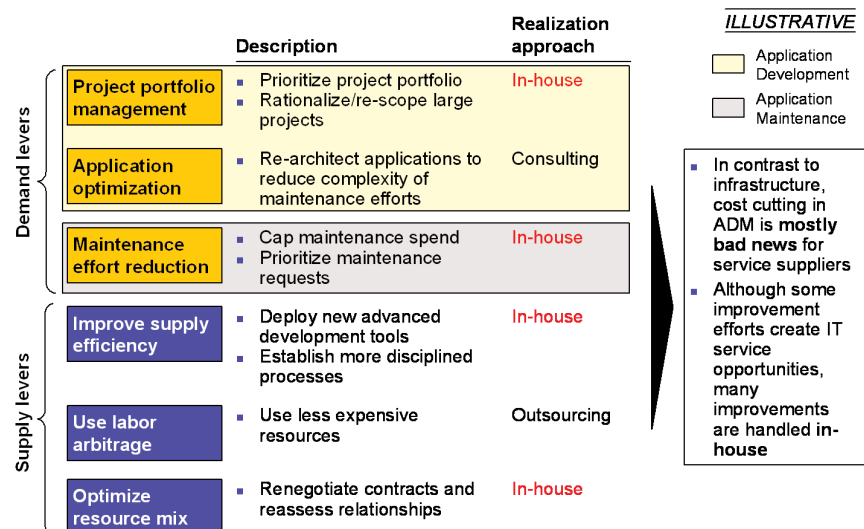
Both supply and demand cost-cutting levers are utilized in ADM (see **Exhibit 5**). Application development cost is cut by managing demand through rationalization of project portfolio. Re-architecture and re-scoping of applications lead to reduction in maintenance costs. Application maintenance spend-cut is more challenging to achieve and is largely managed in-house through prioritizing maintenance requests and re-architecting the solution.

Better discipline, contract renegotiations, and offshoring are major supply cost-saving levers across ADM. Most supply levers other than outsourcing are managed in-house, making overall cost-cutting initiatives in ADM bad news for service suppliers.

EXHIBIT 5

Cost-saving levers in ADM

Sources: Bernstein Research, Everest Research Institute



The cost-cutting effect in consulting (see **Exhibit 6**) largely depends on the type of consulting service. As seen before, buyers widely use consulting to achieve cost-cuts in infrastructure as well as IT operations. Therefore, for these two categories, a downturn may turn out to be a blessing.

An economic downturn has mixed effects on projects more diverse in nature (e.g., IT strategy, infrastructure roll-out, and data management). Management has the option of re-scoping work on these efforts to manage cost, while maintaining the critical components.

Projects with a deeper impact into existing systems (e.g., system integration, legacy modernization, and package implementation) are likely to suffer most under strained economic conditions due to their “dispensable” nature. Most such projects require strong business cases and demonstrable positive impact on revenue to go past the tightening budget strings.

EXHIBIT 6

Effects of cost-cutting on consulting

Sources: Bernstein Research, Everest Research Institute

Consulting segments		Rationale
IT operations consulting	Mostly good news	<ul style="list-style-type: none"> Operational improvements and infrastructure changes are critical pieces of many cost cutting efforts Additional opportunities are likely to be presented
IT infrastructure consulting		
IT strategy consulting	Mixed effects	<ul style="list-style-type: none"> These projects are very diverse in nature, hence they can be re-scoped to cost-cutting/efficiency improvement if necessary
Infrastructure rollouts		
Data management		
Package implementation	Mostly bad news	<ul style="list-style-type: none"> PI and SI projects tend to be long and expensive, hence they tend to come up as the first candidates for postponement/re-scoping
Systems integration		

2008 IT Spending Dynamics

Analysis indicates that the IT services industry might be entering new paradigms, becoming less cyclical than before

EXHIBIT 7

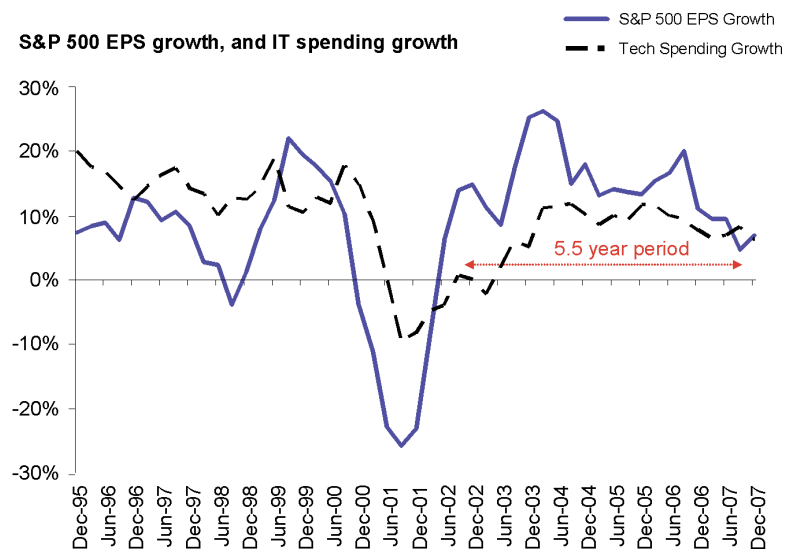
IT spending has become less cyclical

Sources: First Call, Bernstein research, Everest Research Institute

So, is an impending downturn in the U.S. economy really going to adversely impact the IT services industry?

Analysis of recent reaction of IT services to economic slowdown shows that we might be in a less cyclical paradigm. **Exhibit 7** shows that the growth of technology spending with respect to the S&P 500 growth reveals IT spending growth has been slower; indicating that it has become less cyclical than in the past.

S&P 500 EPS growth, and IT spending growth



Moreover, despite a significant U.S. economic slowdown towards the end of 2006, ADM growth has remained steady, even after a more than six-month lag. This indicates that ADM is becoming less dependent on economic health in driving up services revenues. Companies had brought good cash reserve into 2007, which may prove indicative of healthy spending on ADM. Indian IT services firms have also witnessed accelerated growth in the recent past.

The industry's response has been captured in the result-set of a survey conducted jointly by Bernstein Research and Everest Research Institute, which reveals interesting observations. The survey (yielding 377 survey respondents), queried about five IT services segments (i.e., business consulting, IT consulting/system integration, application development, application maintenance, and infrastructure outsourcing; note that BPO/processing was excluded), with each of these segments broken further into onshore vs. offshore components. In inquiring about spending sensitivities in each segment, our survey asked respondents to assume that the customer's business environment would substantially weaken. Therefore, our survey results could be more pessimistic than the actual results that would occur in a U.S. economic slowdown; given that U.S. economic weakness may not substantially and uniformly impair business for customers in all verticals.

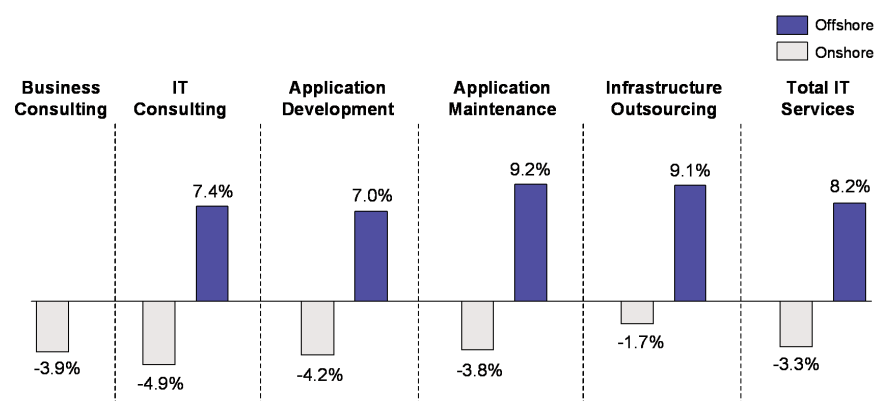
Our survey results show that, in a substantially weaker business environment for all customers, spending across IT services segments would likely show a “mixed bag” of outcomes, with spending affected both negatively (e.g., lower spending on certain discretionary services) and positively (e.g., increased usage of certain services that promise cost savings). Key findings include:

- **No extreme risk revealed** – If customers’ businesses were to substantially weaken, spending across onshore IT services segments in the aggregate would be prone to decline by a modest 3.3 percent.
- **Different spending tendencies for offshore vs. onshore spending** – The difference between onshore and offshore spending tendencies persisted across all IT services segments and was most pronounced for the application maintenance segment, reflecting an expectation that a weaker economy will lead to further shifting of application maintenance work to offshore locations. Indeed, we believe a weaker economy will facilitate further share shift favoring offshore businesses (see Exhibit 8).
- **General consistency between suppliers’ and buyers’ views** – Buyers and suppliers were generally aligned in their views on IT spending patterns in 2008.
- **Limited visibility into 2008 budgets, particularly in the financial services vertical** – Only 18 percent of the respondents in the financial services vertical (39 percent in other verticals) already have visibility into their 2008 budget, and 45 percent of the respondents in the financial services vertical (19 percent in other verticals) will only get clarity on their 2008 budget after three or more months.
- **Financial services customers are more offshore oriented** – Respondents in the financial services vertical were consistently more negative about onshore spending sensitivities than respondents in other verticals (this held true across all IT services segments), and financial services respondents showed more propensity for significant increases in offshore spending.

EXHIBIT 8

IT spending survey analysis

Source: Bernstein-Everest joint survey on IT spending patterns



The survey also reveals that offshore spending is slated to grow, which is in line with the need to cut cost through adoption of labor arbitrage.

Conclusion

The world is expecting a U.S. recession in the wake of changing economic scenarios. Therefore, the effect of a downturn on worldwide IT spending patterns in the different categories (ADM, infrastructure, and consulting) has been a matter of keen interest and concern.

The different IT services categories are aligned along two broad types: project-based and activity-based work. Depending upon the end objective and model of delivery of these services, they are likely to witness different effects of economic slow-down and resultant cost-cutting in organizations, as follows:

- Project-based spending is initially resilient to cost-cutting but can drop meaningfully in a sustained business downturn, typically lagging the economy
- Activity-based work has a longer-term nature and, due to business criticality, cannot possibly be switched off

ADM generally reacts negatively to cost-cutting, as it is more project-based in nature and most of the cost-cutting is achieved through limiting demand of these services.

IT consulting has a mixed effect, due to certain cost savings achieved through consulting.

Infrastructure outsourcing is the least sensitive to the economic conditions. Moreover, the majority of the cost-cutting in infrastructure budgets happens through infrastructure consulting and restructuring and re-purposing of the existing infrastructure backbone.

A joint survey of IT services buyers and suppliers reveals that offshore spending is more likely to sustain positive growth, as opposed to the onshore budget, with the financial industry showing maximum enthusiasm for offshore model. Though there is limited visibility into 2008 IT budgets, financial services firms appear more geared to adopt the offshore model of IT service delivery.

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