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Inside Outsourcing ™

BRIDGING BUSINESS AND TECHNOLOGY

INTERVIEWED BY LARRY JANIS

Inside with:

Julie Santoriello

Vice President, Research, Morgan Stanley

Morgan Stanley is a leading global financial services firm providing a wide range of investment banking, securities, investment management, wealth management and credit services. The firm's employees serve clients worldwide including corporations, governments, institutions and individuals from more than 600 offices in 33 countries.

LJ: What is your view on how the outsourcing industry evolved/ changed over the last 5 years?

JS: The last 5 years have ushered in several changes. Most notable is increased adoption of offshore outsourcing, particularly to India. The India-based outsourcers went from roughly 2% global market share in 2002, to over 10% today, and they continue to post very attractive growth rates in the 20-40% range, on average. While they are most known for applications development and maintenance work, they are expanding their offerings to include applications testing, systems integration, ERP implementation, and BPO that goes beyond call centers to include R&D, F&A and analytics.

This has had a clear impact on industry pricing, and hence, revenue growth rates. That is because work at low wage rates means much less revenue than that same work at high wage rates. The offset should be better operating profit margins for companies making the transition, but there is little evidence of this as yet.

Another interesting change is the decline in mega-deals - it has had clear ramifications for the traditional outsourcing providers. As contracts have become smaller in dollar-terms and shorter in duration, providers are challenged to increase the volume of deals, which typically means a change in the sales structure and go-to-market strategy. Those providers who act quickly and demonstrate flexibility, both internally and in working with customers, will survive.

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FROM THE EDITOR

Welcome to our new issue which was redesigned for us by our friends at the Delve Group.

Inside Outsourcing's goal is to provide you with articles of interest and with a forum for the exchange of information in this rapidly evolving industry.

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A corollary to this is the open-ended contract structure, which is typically used in offshore outsourcing – rather than award a fixed-size deal over a specific duration, customers are granting vendors a "hunting license" that defines terms and conditions, but does not guarantee a specific amount of revenue. Again, this requires flexibility and a change in the sales approach.

In general, the long-term, recurring revenue nature of the IT outsourcing business is eroding, and with it, the visibility this sector once enjoyed. Essential is the need for active nurturing of customer relationships, as well as continual investment in new services, delivery capabilities, global presence, industry and domain expertise, and scale.

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LJ: What's the greatest challenge facing the outsourcing industry this year? The next 5 years?

JS: As James Carville so eloquently summed-it-up 16 years ago during another Presidential election year - "It's the economy, stupid." Evidence continues to mount that the US is slipping into recession, and the global economy is likely to follow. This naturally raises concerns over the level of IT spending this year. Furthermore, looking back over past recessions, we invariably see IT services vendors suffer from customer-specific surprises such as bankruptcies, cancelled contracts due to mergers and/or acquisition activity, and shrinking volumes or management changes that drive insourcing.

Longer-term, the greatest challenge in my view is staying relevant to customers. Successful companies are likely to be those more at the extremes – best-of-breed providers of a specific services domain or industry vertical, or, those with global scale.

Those in the middle cannot compete well, at least for investment dollars, since either their revenue, margins, or both will lag the competition.

As I mentioned previously, flexibility and investment are key. For instance, forward thinking companies are pushing new pricing models that can be described as gain-sharing arrangements or share-in-savings. Working with customers on such models and investing in delivery expertise are needed to ensure success in writing and executing these types of contracts. Five years from now, such arrangements are likely to be much more commonplace than they are today, and the early adopters are most likely to gain market share.

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LJ: What are the constraints to growth in ITO? BPO?

JS: In ITO, constraints to growth include maturation (high penetration of the more mature areas of outsourcing), and pricing. Pricing is a factor in growth for ITO vendors with the move offshore. High-bill rate work is replaced by low-bill rate work, so even if the volume piece of the equation picks up, revenue dollars will grow more slowly due to lower pricing. Volume growth should accelerate given high offshore demand, but we have found that shifting delivery offshore can mean 2-3 years of sub-par growth for companies making the transition. Still, we believe it is a necessary price to pay to build the right positioning for the long-term. Furthermore, moving a portion of delivery offshore will increasingly be necessary to tap larger pools of labor. This is because developed countries continue to suffer from a shortage of qualified labor.

In BPO, constraints to growth are more around rate of adoption and complexity. As a less mature sector, BPO stands to grow nicely over the next 5-10 years – demand is high and penetration is low. The challenges come from customer and contract execution – while the latter is improving with experience, it remains difficult to manage and get buy-in from multiple customer constituents. BPO represents much less centralized functions than ITO. With BPO, no longer is the customer's IT department the main relationship driver; now, it is complicated by business-unit-level decision makers, and those employees who often resist outsourcing and/or transformation initiatives.

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Such complexity and non-cooperation has caused many BPO engagements to fall short of expectations for revenue recognition and profit – and caused many service providers' stocks to fall as a result. Expectations around these, therefore, must be kept realistic. Two models are getting increased traction: process-by-process BPO (rather than multiple or even single-tower outsourcing), and when offshoring, 'transfer then transform', so that the labor savings can help pay for the transformational costs.

LJ: Let's focus on BPO for a moment. Where do you see the greatest expansion?

JS: From our standpoint, the areas that seem to be getting the most traction of late are supply chain/procurement and analytics/KPO. Supply chain work tends to have an attractive cost savings/efficiency proposition and requires expertise that many customers do not have internally. Cost savings potential is clear and reliably attained. Analytics is benefiting from customers' desire to mine untapped data within and outside their organizations. These projects tend to be specific and discrete, rather than open-ended and integrated – as such, they are easy to outsource, particularly offshore.

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LJ: How would you compare the onshore versus the offshore providers?

JS: When we speak with outsourcing customers, the distinctions most often drawn are around flexibility and price. Expertise in managing engagements across regions and time zones is typically a third advantage – with all three going to the offshore providers.

From the standpoint of the investment community, offshore providers are typically considered more attractive given their faster revenue growth (25%+) and their higher operating margins (20%+). However, this is largely reflected in their high stock valuations relative to the onshore and multinational providers, though the latter group is seeing some increased investor interest. Low stock valuations, global presence, industry expertise and strong customer relationships are advantages of the multinational providers, and investors are beginning to appreciate them for it.

Most multinationals have made good strides diversifying their labor pools among low-cost offshore locations. They must now make this global delivery capability an integrated part of their value proposition. The Tier 1 offshore firms have made good strides hiring consultants to capture high-end work. The follow-through, as yet, is unclear, and they must now make a more concentrated effort to build this capability and stake out the C-level relationships that the MNCs enjoy.

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LJ: What impact will the work in the government sector have on the providers?

JS: A company with presence in the government sector is increasingly attractive to investors during tough economic times. The thinking is that while commercial IT services will likely slow, government IT spending (federal in particular) can continue to grow, as it is largely uncorrelated to GDP growth. State and local government spending can be affected by lower tax receipts in tough times, but all governments can and often will spend more in a recession to help stimulate the economy.

Compared to the commercial space, the government sector typically carries lower growth rates and lower margins for outsourcing providers. It does, however, drive strong cash flow since government is a reliable (though sometimes slow) payer and tends to fund its own capital expenditures.

Government IT spending enjoyed a healthy boom in the few years post 9/11, with multiple modernization and integration projects at the Departments of Defense and Homeland Security, as well as the Intelligence agencies. President Bush's Management Agenda was also a boon for IT early in his administration, with its emphasis on e-government, standardized enterprise architecture, COTS software, and outsourcing.

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In Bush's second term, however, the escalating cost of the wars in Southeast Asia have taken a toll on the available budget dollars as well as his mandate. IT spending has since been flattish, and may remain growth-constrained as long as Defense spending dominates fiscal budgetary decisions. Opportunities for above-average growth remain, however, in areas such as cyber-security, health-care solutions, state Medicare/Medicaid systems, and C4ISR.

Of the current candidates for President, none seems to have an especially pro-IT agenda. Our research suggests that, broadly speaking, Obama seems to favor increased use of IT to drive efficiency, while Clinton has called for a rather dramatic shift in the number of government jobs from outside contractors to government employees over the next 2-4 years. In IT, we see little likelihood of such insourcing given the existing shortage of skilled IT labor within the Federal government. Both candidates have mentioned eliminating tax credits to companies who move jobs offshore - Obama most recently - but we suspect that the competitiveness of corporate America will take precedence, and legislation may be limited to incentives to keep jobs in the US.

We have seen estimates that anywhere from 30-50% of federal IT personnel are eligible to retire starting this year. As these employees retire, the government will need to increasingly rely on IT outsourcers, making this customer segment an attractive, long-term growth opportunity for such providers.