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Global Sourcing Trends in 2006

By Alistair Maughan

At the start of 2006, we have once again informally surveyed the views of the partners in Morrison & Foerster's Global Sourcing Group based in Europe, the United States and Asia. This update collates Morrison & Foerster's experience of a wide range of sourcing projects in a number of geographic and sectoral markets, comments on the state of those markets and suggests some trends to look out for in 2006.

One view of the state of the sourcing market could be that 2006 will offer more of the same. While valid at one level, we believe that that view overlooks some underlying developments. Twelve months ago, Morrison & Foerster's annual review of the sourcing market concluded that the key features of the industry during 2005 would be the continued rise of offshoring, the expansion of the business process outsourcing (BPO) market, a continued trend of deal re-alignment and, in particular, the growth of multi-sourcing as an alternative to single "mega-deal" contracts.

All of these trends have played a significant part in sourcing over 2005 and look set to continue into 2006. We provide below an overview of some key aspects of the sourcing market, and then examine in more detail below the

outlook for multi-sourcing, BPO (especially HR Outsourcing), and Offshore projects. We also survey some key geographic trends, vendor trends and the phenomenon of "back-sourcing". We also predict that issues in data privacy and security will become more important.

Our conclusions of the state of the sourcing market at the start of 2006 are that, firstly, because offshore is now merely a means to an end rather than an end in itself, 2006 may be the year when offshore and onshore become inextricably blended and, secondly, the sourcing market remains a buyer's market.

OVERVIEW: MORE OF THE SAME, BUT DIFFERENT

Looking forward, at the top level, the overriding trends that we see are continued growth in services globalisation and a proliferation of sourcing options. In short, clients are thinking more broadly and more strategically about their sourcing options. It is no longer true, if it ever was, to talk about a single "outsourcing" market: the real secret of sourcing success is in "right-sourcing" – i.e., choosing and then successfully implementing the right strategy for each organisation at a particular point in time.

Continued on Page 2

We expect to see a number of features develop over the course of 2006. Overall, spending on outsourced services is likely to continue to grow. Our own “survey of surveys” (an attempt to make sense of the huge variation between reports of the size of the sourcing market from different organisations such as

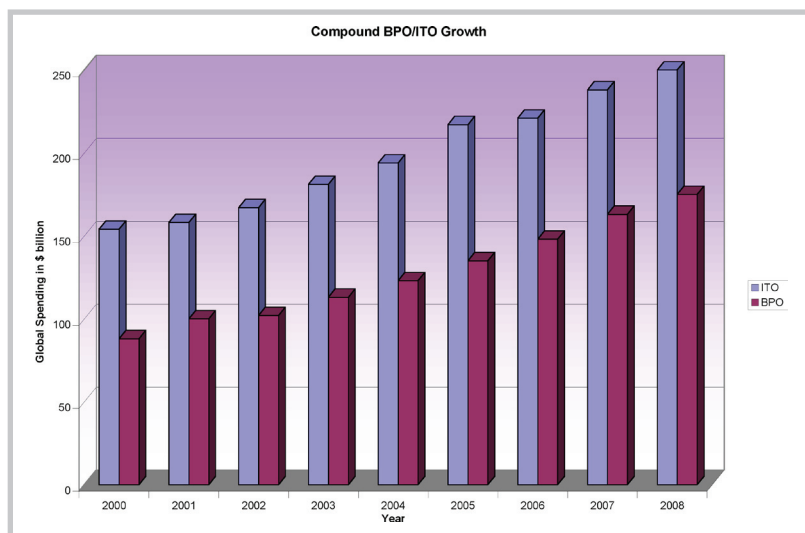
(PO) and Finance & Accounting Outsourcing (F&AO) may be now. We expect more PO and F&AO projects to come on-stream as the year progresses.

The good news for organisations thinking about outsourcing is that the increased prevalence of the vari-

to that dominance. In fact, a number of the key Indian vendors are intelligently reinventing themselves in order to retain market leadership. If anything, 2006 could be the year when offshore came onshore.

MULTI-SOURCING

There are now, more than ever, a wide range of sourcing options available. Perhaps it is simply the current phase of the global economy, but in both the United States and Europe we often now find that many of our sourcing clients are moving away from simple achievement of costs savings as the key driver of outsourcing. We hear more often about a greater desire for improved operational efficiency and accelerated growth of clients’ businesses – and that is going to require organisations to look increasingly at more integrated, less discrete sourcing options.



Gartner, IDC and ComputerWire) shows maturity in the IT Outsourcing market and continued above-average growth in BPO.

In part, sourcing growth will be fuelled by companies finding new areas – beyond those traditionally considered as right for outsourcing – which can be put out to third parties. HR outsourcing (HRO) has become one of the main areas where we are working on projects for clients. And our general sense is that where HRO was 12 months ago (i.e., more talk than action), Procurement Outsourcing

ous offshore delivery models will keep up pressure on pricing amongst the vendor community. And, indeed, customers are well advised to watch the vendor community closely, because trends there can affect the shape of sourcing projects (witness the rise of the large Indian vendors over recent years) in terms of the options available in the marketplace.

Notably though, while China and other offshore locations continue to develop and to nibble away at India’s dominance of the offshore landscape, there is no sign yet of an end

In many cases, a number of organisations have already been through rounds of cost cutting that have already picked off much of the low hanging fruit of cost savings. This means that they need to look increasingly towards sourcing as a way of driving incremental efficiencies over and above merely reducing the cost base.

Over the course of the past 3 years, the value of the average sourcing transaction has progressively declined, reflecting the trend to multi-

sourcing and the lower cost base of offshore vendors. Customers are increasingly splitting up deals that would previously have been put with a single vendor. ComputerWire routinely tracks average deal size and has reported just 15 announced deals in 2005 with a value in excess of £1 billion compared to 25 deals in 2004 and 29 in 2003. However, the other side of the mega-deal coin is that more contracts are being split between a number of different suppliers. During 2005, ABN Amro signed 5 year deals with 5 separate vendors – to set alongside its existing desktop deal with EDS. The most eagerly awaited outsourcing deal of 2006 will be the General Motors project in which GM is expected to break-up £15 billion of contracts between a number of different suppliers. As with other customers, GM's aim is to receive more flexible, best-of-breed services.

Gartner estimates that, by 2008, 70% of organisations will be using four or more IT services providers – although it also says that only 30% of those organisations will have the right skills in order to manage multi-sourcing contracts. And this really highlights a key issue with multi-sourcing: making it work requires strong but flexible governance, and more effort, resource and skills. Organisations need to ask themselves whether they have the right commitment and skill-sets to release the value that multi-sourcing offers.

BPO

Sitting alongside the growth of multi-sourcing is the acceleration of business process outsourcing. This is fuelled by the core of BPO which has traditionally been the outsourcing of front and middle-offices and which still represents over 70% of the BPO market. However, the growth of back-office outsourcing will be particularly strong over 2006.

HR outsourcing in the latter half of 2005 in fact underpinned the continued growth of the BPO market and is likely to fuel further growth during 2006. Andrew Smith of our London office has highlighted already the skills needs to succeed in HRO (<http://www.mofo.com/news/updates/files/update02122.html>), and we are running seminars on this topic in London, California and New York in January and February 2006 (<http://www.mofo.com/events/HROutsourcing/index.html>).

Procurement outsourcing has been slow to achieve traction but customers are coming to realise that PO offers the opportunity to secure a potential double benefit of, firstly, savings on operational costs at the time of outsourcing but, subsequently, savings on goods and services procured through better re-negotiation with suppliers. Typically, a large organisation's indirect spend accounts for 20% of revenue, so if an outsourcer can deliver savings on that around the 10% mark, PO is an attractive proposition.

More Finance & Accounting outsourcing is also likely although, even with projects currently underway, any real increase in F&AO seems unlikely until the second half of 2006 at the earliest. The take-up of F&AO has, until recently, been held up by a preoccupation with Sarbanes-Oxley compliance. But now that most CFOs have got to grips with the tasks required in order to make their internal processes compliant, and CFOs now have the time and budget to look to outsourcing, then F&AO may be a more palatable solution.

OFFSHORE

It is Motherhood and Apple Pie to say that offshoring will continue to grow in 2006. A number of surveys and reports have already pointed up a close correlation between the proportion of a vendor's workforce that is based offshore and profitability. Offshore is now no longer a dirty word – indeed, in Europe it never really acquired the taint given to it by 2004's US presidential election and a slew of state anti-offshoring legislation (<http://www.mofo.com/news/updates/files/update02031.html>).

India, of course, remains a leader in offshoring. China is still some way behind and remains more focused on software applications and at the Japanese market and sub-offshoring

Continued on Page 4

market than at broader IT services and the West. But as Fraser Mendel of our Beijing office has pointed out elsewhere, there are measures that companies can take to maximise the advantage of offshoring to China (<http://www.mofo.com/news/updates/files/update02097.html>).

India itself is in what The Economist has described as the third stage of its growth. The first stage was development of world-class applications development skills when firms like TCS became partners with Western firms for low cost development. The second stage was Indian firms and captives offering low-end back-office services (call centres, transcribing medical records, processing insurance claims etc.). And the third stage is currently true both in ITO and BPO, where ever more complex services are now being provided.

Our impression is that over the past 12 months, the sourcing market has shifted to the point at which many clients no longer specifically contemplate an offshoring transaction: it has become accepted that offshoring is likely to be a constituent part of a service solution and the issue becomes one of extent. Customers are more prepared to leave it up to vendors to make the right choice as to how savings can be achieved through some form of offshoring. This points up the issue for many of the mid-sized vendors that their future competitiveness is increas-

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ingly likely to be dependent upon the degree to which they can move headcount offshore in order to drive up margins and compete effectively with both the Tier 1 and the indigenous offshore vendors.

GEOGRAPHIC TRENDS

In the United States and Europe, the sourcing markets remain very buoyant. In the US, the outsourcing market is expected to grow by average 9.3% over 2005-10. A key driver will be increased adoption of BPO as companies prioritise the outsourcing of key business processes.

In Europe, the UK remains the biggest market for BPO deals and, generally across Europe, demand for outsourcing is growing (although still lagging the US and UK, which one might say reflects a normal lag of European countries adopting technology relative to the United States). Sourcing advisers TPI reported last year that Europe is now the biggest market for outsourcing – with 49% of all new contracts in 2004 and, for example, Germany is now 12% of the world market from virtually zero in 2001.

In Asia, of course, the sourcing market is supply-side driven. But the biggest Asian economy of them all,

Japan, remains the enigma of the sourcing market. According to a recent IDC survey, 14.8% of Japanese corporations have used IT outsourcing for more than 3 years; 19.8% have considered IT outsourcing but decided against it; but a startling 50.9% of Japanese corporations are not currently considering the use of IT outsourcing. This reflects the experience of Morrison & Foerster's own Tokyo office – the largest of any foreign law firm in Japan – which sees plenty of joint manufacturing and research projects, but a relatively low incidence of traditional outsourcing projects.

It seems that the key to the future success of the Japanese outsourcing market lies not just in address-

ing pricing, security and service issues, but in how well vendors can surmount the degree of cultural resistance to outsourcing that exists there. If the vendors can unlock the Japanese market, that could be the next big driver in growth for the global sourcing market.

VENDOR TRENDS

As Mark Twain would have it, reports of the death of Tier 1 have been greatly exaggerated. 2005 was a year of the Tier 1 vendors retaining much of their market power. IBM, EDS, Accenture and CSC remain the most significant players in the global sourcing market and they continue to dominate the landscape. Even CSC, which at one point during 2005 (and again in the first week of 2006) was threatened with break-up, rallied at the end of the year and signed-off the year with a succession of good contract wins. Admittedly, a number of those were in contract extensions – but they were, by anyone’s measure, large contract extensions and, as we noted 12 months ago, a vendor’s success at retaining business at the second generation stage is a good indicator of its quality as a services provider and should not be overlooked in favour of more headline-grabbing new business wins.

The major offshore vendors have continued to expand in 2005. Of

course, the phrase “offshore vendor” really still means the large Indian-origin vendors. None of the vendors from other competing offshore jurisdictions have yet anywhere near the degree of skill required to compete with the well-established Indian vendors. But companies such as TCS, Infosys and the newly independent Genpact have all made considerable strides in consolidating their existing core businesses such as applications development and maintenance, and in expanding into new geographies, new vertical markets and new horizontal skill-

sets. In part, this has been through acquisition of niche onshore-based providers in order to acquire scale in core BPO skill-sets, but it has also been through an expansion of traditional ITO skill-sets – i.e., moving away from purely software based services into onshore BPO (<http://www.mofo.com/news/media/files/pr02035.html>) and areas such as remote infrastructure management, a

traditional core skill-set of the large global IT vendors.

But the sector of the vendor community that perhaps is most vulnerable at the beginning of 2006 is the mid-tier community which risks being squeezed between the big global players and the rapidly expanding offshore vendors. The mid-tier vendors actually are well placed to compete for multi-sourcing work but to do so they need to reduce their cost base, improve margins and generally position themselves to acquire and defend market share.

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Both the large Tier 1 providers and the offshore Indian vendors have identified acquisition strategies in order to gain credibility and size in certain sectoral markets – especially in the key battleground of HR outsourcing. Acquisitions and market consolidation will be one of the trends of 2006.

Continued on Page 6

DATA PRIVACY AND SECURITY

The last of our predictions for 2006 is that issues in data privacy and security will become more widely appreciated as key issues in the worldwide sourcing market.

Around the world, governments are reacting in different ways to the issues posed by cross-border data transfers and data security breaches. Regardless of the differences between countries, it is axiomatic that failures in data security in a sourcing transaction will likely lead to some combination of fines, loss of customers, and potential litigation.

As a number of financial institutions have discovered, the real cost can be damaged reputation: it is neither adequate nor acceptable to say: "sorry, it was our outsourcing vendor's fault that your account details got released". So we find that our clients – especially in the financial services industry – are paying more attention than ever before to strategies to anticipate and prevent data security breaches. And this means going well beyond merely complying with the letter of the various laws on data privacy and protection.

BACK-SOURCING

Finally, a riddle. When is a trend not a trend? Answer: when it involves organisations "back-sourcing" – i.e., taking back in-house services that were previously outsourced. JP

Morgan Chase did it with IBM in the wake of the Bank One merger. Banco Santander has said that it is back-sourcing some of Abbey's IT operations, and UK retailer Sainsbury's announced that it is bringing back in-house its multi-billion outsourcing with Accenture. So surely this is a significant trend?

In fact, this particular device has always been a feature of the sourcing market and illustrates a number of the points already highlighted above – that securing and expanding existing relationships is a key task for vendor success. But it also shows that there are many ways to skin a cat and whereas once it may have been the case that outsourcing was only ever one-way, now one of the features of the sourcing market is that some degree of in-house provision sitting alongside a multi-source solution could increasingly be a part of the sourcing landscape.

Indeed, one of the natural corollaries of the move towards multi-sourcing is that organisations must be prepared to invest more in terms of governance and relationship management. Our clients' experiences suggest that the internal cost of proper governance is in the range of 8% to 20% of total contract value, with the higher numbers being more appropriate for the more complicated multi-sourcing environments. If that is the case then organisations may well simply seek to capture a greater part of that value by retain-

ing internally functions that they know they can do better than many of the vendors, thus linking some degree of back-sourcing as part of a multi-source trend.

CONCLUSIONS

Twelve months ago, we said that offshoring is now deeply rooted and will continue to form part of many transactions. That remains the case: offshore is now merely a means to an end of improving the value inherent in sourcing transactions rather than an end in itself. But the expansion of many key offshore providers into traditionally onshore deals, when combined with the significant growth in wider BPO projects, means that 2006 may be the year when offshore and onshore become inextricably blended.

Offshore delivery models have forced suppliers to become more price-competitive; clients are becoming more sophisticated and learning from their own and others' deals; and there are more external advisers to advise on correct approaches. These factors, along with the development of more and alternative sourcing options, means that sourcing in 2006 is, and should remain, a buyer's market. The key to success for companies considering sourcing projects is how to position themselves to maximise the value on offer in the sourcing market. ■

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