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Global Sourcing Trends in 2008

By Jon Edgell (London), Gabe Meister (New York),
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At the start of 2008, we have once again surveyed the lawyers in Morrison & Foerster's Global Sourcing Group in key markets in the United States, Europe, and Asia. This update collates Morrison & Foerster's view on the state of the global outsourcing market and our lawyers' experience with a wide range of sourcing projects in a number of geographic and sectoral markets.

This year, three of the partners in our Global Sourcing Group – based in Asia, Europe, and the United States – comment on the state of the outsourcing market from their viewpoint and suggest some trends to watch out for in 2008. Their views are based on what they have seen in their outsourcing projects over the past twelve months, as well as on the views expressed by service providers, outsourcing consultant colleagues, and our clients.

EXECUTIVE SUMMARY OF OUTSOURCING TRENDS

Global Trends

Cost, not value An economic slowdown will see a move back towards cost-driven outsourcing – despite the fact that, over the long term, service-driven or value-driven deals tend to deliver more stable, successful relationships.

Post-signature Project Management We see greater emphasis on post-signature support, governance, supplier management, and the role of the retained function.

Pharma and Life Science Outsourcing As the pharma industry sharpens its focus on the core competencies needed to sustain its pipeline of new drug candidates, we expect to see increased pharmaceutical outsourcing in 2008 and thereafter.

Green IT As all companies seek to reduce their corporate carbon footprint, we expect to see a greater take up of outsourced services that deliver “Green IT”.

Asia

Can India still Dominate? Yes, it can. Indian vendors reported strong earnings and growth for 2007. Current trends support continuing Indian dominance of the offshore market. But, ironically, Indian vendors are driving up the Chinese offshoring market.

China Grows Outsourcing in China will continue to grow in 2008, and probably at a moderately increased rate. Much of the work outsourced into China comes re-routed by the main Indian service providers, not direct from end customers.

Captives in China The pattern of use of captive outsourcing entities – a concept developed in India – will be followed in China.

Japan There is an increased acceptance of the outsourcing model in Japan, with foreign corporations looking to lay-off high costs in Japan to lower-cost jurisdictions like China.

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Europe	
<i>Europe Awakes</i>	One of the sleeping giants of outsourcing – continental Europe – has awoken. 2007 saw more outsourcing initiated in Europe than in the United States. This will continue.
<i>Central and Eastern Europe</i>	It may not be a new India but Central and Eastern Europe has made itself a viable offshoring destination.
<i>Data Privacy and Security</i>	Recent headlines about data security breaches have re-focused public attention on how data is handled. This issue has always been a key part of outsourcing decisions. The difference is that the price of failure is now much greater.
United States	
<i>The Weak Dollar</i>	The declining U.S. dollar affects service providers' bottom lines, changes behaviors, and may lead to more mid-term re-negotiations.
<i>The 2008 Presidential Election</i>	Will history repeat itself? The last Presidential election spawned a raft of state anti-offshoring laws. But the creation of onshore jobs by offshore providers this time around may take the heat out of the issue.

GLOBAL TRENDS

Twelve months ago, Morrison & Foerster's annual review of trends in the sourcing market anticipated a trend toward smaller, shorter deals; an increased reliance on global service delivery models; an expansion of offshoring to Asia; increased adoption of elements of IT and business process outsourcing by Japanese companies; Europe, becoming an engine for outsourcing growth; and heightened awareness of privacy and data security issues by sourcing customers. For the most part, these trends have indeed developed over the course of 2007 and, in our view, will continue to develop in 2008.

Cost-Driven Deals

There is little doubt that, in the early days of outsourcing, cost saving was one of the primary drivers of outsourcing deals. However, as both customers and service providers matured, it became

clear that focusing on cost savings alone was merely scratching at the surface of the potential of outsourcing. Customer organizations realized that the service providers really were experts in their chosen fields and that outsourcing offered a range of additional benefits such as access to new skillsets, best-of-breed services, greater innovation and transformation, and better speed-to-market for new products and services.

In fact, we started to see deals that were cost-neutral or even reflected a higher cost, but in return for an enhanced service offering. And the service provider community realized that cost, while important, was not the only criterion for winning or losing deals. As bid processes became more competitive with a greater number of competent service providers entering the market, service providers had to tailor their offerings to ensure that they could win the battle not only on cost but also in the areas of "added value".

As a result, the drivers for outsourcing deals have been cyclical. In slower economic times, cost has played a more significant factor, while, in better times, the other benefits of outsourcing have received a greater focus. In light of the predicted economic slowdown in 2008, we believe that cost will again become more prominent. This seems almost inevitable.

But, as in previous economic slowdowns, this tightened focus on cost over value needs to be approached with caution. "Outsource in haste, repent at leisure", to paraphrase the old proverb. Outsourcings driven by cost-saving issues tend to be short-term solutions. Companies should look back to previous economic cycles and appreciate that projects driven by value or service issues tend to be more successful.

The Post-Signature Phase

There has been a notable shift in the quality of outsourcing contracts that have been put in place over the last few years. Five or more years ago, companies experiencing problems with their outsourcing relationships often had in place very poor-quality contracts. In light of the lack of clarity in the contracts, it is no surprise that there was a mismatch of expectations between the customer and the vendor – and relationship breakdown was an almost inevitable consequence.

As the market has matured, we have seen a significant increase in the quality of the typical outsourcing agreement. However, the number of disputes has not diminished, and customer satisfaction does not seem to have increased (possibly in part due to rising expectations). On examination, it is clear that many of the contract management mechanisms in place (e.g., governance regimes, service level measurement and reporting, balanced scorecards, gain-sharing, innovation and improvement forums, etc.) either are not being used or are being implemented poorly.

In light of this, we believe that in 2008 outsourcing customers generally will pay greater attention to the post-signature phase. Our clients are already placing a greater emphasis on contract governance and management, and we are being asked more and more to help with the design and running of the retained function. We are also seeing a far greater incidence of six month reviews where the negotiation team and the contract management team of the customer work together to identify areas that are working well, areas that require improvement, and activities that are not taking place but should be. This is also leading to an increase in the number of midterm re-negotiations – a trend that we believe will continue.

Pharmaceutical Offshoring

Offshoring of critical functions by pharmaceutical companies – particularly to providers in China and India – showed signs of growth in 2007, and we expect this growth to continue in 2008. As competition from generics increases and patents on more and more big-ticket pharmaceutical products approach their expiration, pharmaceutical companies are looking for new ways to cut costs and focus on core competencies such as late-stage product development and sales and marketing in order to sustain their respective drug pipelines.

To accomplish these goals, we have seen the pharmaceutical industry increasingly willing to outsource not only “traditional” IT and business processes, but also functions that some would consider within what were previously considered pharmaceutical companies’ core competencies – including the manufacture of active pharmaceutical ingredients (APIs) (the key ingredients of drugs), clinical research and development activities and clinical data management.

Offshoring the manufacture of APIs to India and China can win large cost savings and allow companies room to re-focus on core competencies. Similarly, offshoring the conduct of clinical trials can provide access to previously-untapped large patient

populations with unmet medical needs and can greatly speed the recruitment of study subjects.

Of course, there are potential perils: moving the manufacture of critical drug components or the management of clinical trials or data overseas carries quality control issues, legal and regulatory risks, and raises potential intellectual property concerns (as we have previously explored – see http://www.mofo.com/international/CN_en/news/update02097.html). Nevertheless, U.S. and U.K. pharmaceutical companies in 2007 expressed increased interest in offshoring critical functions. Pfizer and AstraZeneca have each discussed large-scale plans to offshore manufacturing activities (including AstraZeneca’s manufacture of APIs), and Eli Lilly, Bristol-Myers Squibb, and Wyeth Pharmaceuticals have outsourced certain high-level drug discovery and development functions to Indian firms.

As the industry sharpens its focus on the core competencies needed to sustain its pipeline of new drug candidates and, ultimately, on its own bottom line, we expect to see further pharmaceutical outsourcing in 2008.

Green IT

During 2008, as environmental concerns continue to grow globally, there will be an increased interest in the

use of “Green IT”. Green IT covers a broad range of measures aimed at reducing the environmental impact of corporate IT use.

We are already seeing customers seeking more energy-efficient IT solutions. This includes making even greater use of the sort of virtualization techniques that have traditionally been rolled out to reduce server estate running and maintenance costs, and working towards reduced corporate energy consumption, particularly in high energy use areas such as data centers. We see outsourcing customers insisting on the introduction of energy-efficient best-practice standards and processes (and even data centers powered by environmentally friendly energy sources).

Already, we have seen service providers putting greater emphasis on their green credentials and, as more and more customers seek to reduce their corporate carbon footprint, we expect to see a greater take-up of services that make use of Green IT.

ASIA

The Indian Success Story

The success of Indian-origin service providers is a mega-trend of the past decade. Most of the main Indian vendors reported strong earnings and growth for 2007.

The development of best-of-breed service offerings as an alternative to global mega-deals (on which we reported 12 months ago), combined with current market trends could leave the Indian vendors in an even stronger position than in the last few years. And native Indian businesses themselves have begun to discover outsourcing, fuelling a growing Indian domestic outsourcing market.

But given rising costs in India, cost squeezes could give a real opportunity to other, cheaper offshore jurisdictions. The question is: are those other jurisdictions, particularly China, ready to ride this wave, or will they have to wait for the next one to come along?

China Grows; but the Gap Remains

We expect the growth of sourcing from China to continue in 2008, and probably at a moderately increased rate.

Twelve months ago, we predicted increased offshoring to Asia as clients became more confident about doing business in China. And, indeed, 2007 continued to see more and more work being done in China, although at a modest rather than dramatic rate of increase. Most (but not all) work is being done by the Chinese operations of the major Indian service providers, rather than by indigenous Chinese service providers.

Although China does still have clear cost advantages (in particular for applications development and maintenance (ADM) work), costs are rising, especially in the major centers on the east coast of China, as the major Indian service providers have discovered. But despite this, the combination of a weakening U.S. dollar, growing fears of a significant U.S. economic slowdown, if not recession, a growing confidence in and familiarity with China, and the continuing cost advantage, have still resulted in the main Indian vendors re-routing work increasingly to lower-cost jurisdictions, and in particular their operations in China, as part of their global service delivery model. This trend will continue in 2008.

Captives

Captive outsourced entities (i.e., wholly-owned outsourcing subsidiaries of large corporations) have long been a familiar part of the Indian outsourcing scene. In many cases, these have gone full circle and been floated or sold off (e.g., WNS, Genpact).

While the use of captives continues in India, the pattern of captive development is being followed in China. As familiarity with the legal and commercial issues in China increases, so too have mechanisms to minimize the perceived risks involved. In Asia, we have tracked the development of the captive (or quasi-captive) sourcing model to contain

these risks, with several multinational corporations with operations in Hong Kong and elsewhere in Asia either setting up their own sourcing operations in China, or funding a third party service provider in China, directly or indirectly, who then has that company's Asian (and sometimes global) operations as its primary, if not exclusive, customer. This trend will continue this year.

Japan

Japan remains an idiosyncratic outsourcing market. There has been a clear trend over the last 18 months for U.S. and European multinational corporations (in particular, large financial institutions and insurance companies) to look to lay off some of the very high costs in Japan to lower-cost jurisdictions, especially China. Interestingly, we sense for the first time that some of the cultural taboos on outsourcing may be eroding, but this is a very slow process.

For the most part, any outsourcing activity has mainly been on a "trial" basis, often starting with ADM. And it is also a much greater feature of the operations of foreign-origin companies with operations in Japan, than the large Japanese corporations. But we expect more and more corporations of this type to look at reducing high costs in Japan by adopting this approach in 2008, and as those that have tried this approach in 2007 be-

come more comfortable with the results, it is likely that the volume of their work will increase as well.

EUROPE

The Growth in the European Outsourcing Market

A year ago, we said that "continental Europe will be an important driver of new deals". And so it has proved.

The sleeping giant on the demand side, continental Europe, has woken up. 2007 saw a marked increase in the market there, and the level of its increases outstripped all other regions. One of the leading outsourcing consultants, TPI, reported that in 2007 Europe outpaced the United States for the first time for IT outsourcing.

From conversations with our clients, we believe that 2008 will continue this trend, possibly with fewer mega deals, but growth will be fueled by "domestic" European deals and the European elements of global deals.

Absent an economic slowdown, as the market continues to mature, we would also anticipate a move up the value chain to see deals with primary drivers other than cost. However, in the light of economic conditions, cost may remain the key driver for a while longer, with the evidence of maturity being delayed until the next cycle when cost is less important than improved service.

Central and Eastern Europe

While not having the same headline-grabbing power as Indian offshoring, outsourcing to countries in Central and Eastern Europe (CEE) has continued its steady growth. Further developments in 2008 should be expected.

The growth in this market is partly customer-driven (i.e., by German, Dutch, and Scandinavian customers who feel comfortable with the culture and language skills of the Czech Republic, Romania, Estonia, etc.) and partly service provider driven (i.e., by large service providers who have invested heavily in facilities in CEE states (e.g., IBM in Prague and Poland, Accenture in Romania) and want to see those facilities operating at maximum capacity). As continental Europe increasingly gets the outsourcing bug, the proximity and cultural affinity to CEE states will help to fuel growth in those countries.

Data Privacy and Security

In the U.K. at least, it has been hard to avoid headlines about data security breaches over the past few months. If it's not lost CDs containing personal data, then it's stolen laptops. Some organizations have been fined for their data security breaches – and others have spent millions on dealing with the consequences and fall out of such breaches (and that's before the unquantifiable damage to corporate reputation is considered).

These recent headlines have re-focused public attention on how data is handled by companies and their outsourcers. But in our experience, this issue has always been a key part of outsourcing decisions and, in practice, no sensible company undertakes an outsourcing that may affect personal data without taking a range of proper precautions.

But what's different now is that the price of failure is much greater. We expect to see companies stressing the importance of data security more than ever before. Service providers will be tied into key performance indicators and governance mechanisms specifically addressing this issue. And the issue of who is liable for what in terms of data security will take center stage as never before.

UNITED STATES

The Weak Dollar

One of the key issues affecting the progress and development of outsourcing in 2007 has been the decline of the U.S. dollar, particularly as against the Indian rupee (a drop in value of roughly 11%). For service providers carrying significant currency risk, and especially for those providers with a large portion of their revenue derived from deals with U.S. entities, the declining dollar cuts directly into their bottom line. If the dollar continues its decline in 2008, service providers may push more aggressively for new means to hedge their respective currency risks

and cut costs overall, both contractually and behaviorally.

The weaker dollar may also lead to more mid-term re-negotiations. Where offshore service providers have taken the currency risk in the initial deals, a continuing decline in the dollar may turn profitable deals into loss-making deals. And, it is important to stress, because of the behaviors that it drives and the loss of incentive to invest, a loss-making deal could be a disaster for both parties, not just the party initially holding the exchange risk. While customers are always reluctant to agree to a price increase, some of the more mature customers may realize that it is in their best interests to ensure that their provider is not in a loss-making situation and so may agree to certain price increases. However, such price increases will come at a cost, and providers will be pushed even harder to innovate and provide more added value.

Where customers have taken the currency risk, the exchange rate fluctuation may blow a hole in what once looked a rosy business case. This could lead not to re-negotiation, but to a mid-term switch to a domestic U.S. provider.

The 2008 Presidential Election

Outsourcing was a key issue during the 2004 U.S. Presidential election as candidates railed against the outflow of U.S. jobs to other countries. That election sparked a wave of state-level anti-out-

sourcing laws (<http://www.mofo.com/news/updates/files/update02031.html>).

Further, the 2006 U.S. mid-term elections saw outsourcing and offshoring invoked frequently as a "wedge" campaign issue. Will the 2008 elections follow suit — that is, will outsourcing again take center stage?

So far, other than a brief mention of "companies that ship our jobs overseas" in Barack Obama's recent Iowa primary victory speech, outsourcing does not appear to have become a key campaign issue. But, as noted above, the U.S. dollar continues to fall, and according to a recent Harris poll over one-third of Americans are "extremely concerned" that outsourcing will affect them personally.

Further U.S. economic woes, including a loss of jobs in the U.S., could bring the outsourcing issue into sharper focus in the 2008 Presidential campaign. If so, it is possible that the continuing trend of "reverse-offshoring" (for example, top-tier Indian vendor Wipro announced in September its establishment of a global software development center in Atlanta, Georgia, where Wipro expects to hire around 500 employees for the facility over the next three years) and the increase in offshore service providers' recruitment activities in the U.S., might soften candidates' positions on the matter. ■

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