KPMG

Confederation of Indian Industry

IT ADVISORY

Changing Landscape of IT – ITES Outsourcing

A case for synchronization of perspectives

KPMG IN INDIA

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1 Foreword

Global economic indicators and analysts suggest that the path to economic recovery may be slow and long drawn-out. In this uncertain environment, outsourcing is being increasingly seen as a business lever providing significant potential for firm to reduce costs and access industry best practices. As strategic business advisors, KPMG member firms have had the privilege of working with many large business houses and outsourcing service providers. We have witnessed the evolution of outsourcing relationships and helped our clients navigate through many challenges. We recognize that this is a rapidly evolving industry with new service models and value propositions being generated on a continual basis.

For many procurers, the key expectation is that service providers understand their business better and offer comprehensive solutions rather than piecemeal services. On the other hand, many service providers are equally influenced by market forces to build standardized solutions and scale, as opposed to customized solutions, in order to meet their growth targets.

Ideal business equilibrium needs to be achieved between the demand and the supply side so that players on both sides derive maximum value from the relationship. This cannot be attained in isolation and often needs consultative discussions and partnering among the involved parties.

In this study "Changing Landscape of IT – ITES Outsourcing: A case for synchronization of perspectives" KPMG India has looked at how the demand and supply perspectives around the key themes of business agility, risk management, process improvement and performance measurement can be better synchronized. We hope this research will throw light around enabling better collaborative partnerships.

Kumar Parakala
Head IT Advisory & Global Head of Sourcing
KPMG in India

2 Introduction

The last two years have changed global business in a significant manner. Businesses have focused on being leaner and have re-examined existing best practices. Market forces have impacted procurers and forced them to reconsider their operating models. These reviews have started to include suppliers of outsourcing services and this has the potential to impact their financial performance and organization models.

Outsourced shared services have become instruments to leverage global cost arbitrage opportunities and increase business agility; however, they are often perceived to be under performing due to lack of focus on customer satisfaction, low degree of contractual flexibility, poor processes and low employee morale. Many procurers have had to expand or relocate to new destinations in order to reduce their cost of operations and maintain margins. Some procurers have "sold and contracted back" their shared services operations to generate cash. Selling such captives also helped increase their focus on client servicing and processes improvement.

Some procurers have started to recognize challenges in widely dispersed operations and have proactively driven process improvement initiatives, even in operations that are managed by vendors. Due to the inadequacy of contracts governed solely by SLA's in helping improve processes, some procurers are restructuring contracts to be governed by assessment criteria in-line with those for internal business units.

Consolidation of processes, applications and technology infrastructure is an important step to reduce the complexity of global operational platforms. Service providers are therefore investing and gaining deeper expertise across Information Technology Outsourcing (ITO), Business Process Outsourcing (BPO) and Information Technology Enabled Services (ITES) capabilities in specific domain areas. A convergence of BPO and ITO providers will likely define many new outsourced entities.

We also believe that the mix of outsourcing procurers is changing both in terms of industries and geographies. Geographically, the developing economies of Asia and Latin America are expected to aggressively adopt outsourcing in order to leverage industry best practices.

The need for globalization, continuous process improvement and consolidation across service provider offerings appears to be tilting the balance in favour of the larger outsourcing players. With the growth in outsourcing by the SME segment, providers may have to scale operations faster in order to adequately service their clients.

K K Raman
Executive Director - IT Advisory
KPMG in India

3 Challenges for Procurers

We are starting to witness signs of recovery from the recession over the past few months. As the world looks at growth opportunities, as with all cataclysmic events, there is a realization that the past twenty four months have irrevocably changed business operations.

Changes that started with the spurt in oil prices have been aggravated by the recession. Businesses globally have witnessed discretionary spends disappear, projects put on indefinite hold and order-to-cash cycles stretched. In an effort to improve their financial situation, many businesses have closely reviewed operations and industry best practices. Our research shows that companies are looking towards technology and outsourcing to reduce costs, increase operating efficiencies and improve customer satisfaction.

> "I can say more such outsourcing will happen"
>
> **Mr. Manoj Kohli,**
> CEO, Bharati Airtel
> at India Economic Summit,
> Nov 2009 commenting on his firm's
> strategy to reduce costs[1]

3.1 Acceptance of Outsourcing as a mainstream option

Organizations have explored new ways of doing business; implemented emergency measures to improve cash flow; overcome negative growth and slipping margins in order to survive. KPMG International's 2009 study "Nearshore Attraction: Latin America Beckons as a Global Outsourcing Destination" reveal that businesses are looking at outsourcing to play a leading role in the coming months to aid economic recovery. With an increase in the number of firms outsourcing, the strategy has gained greater acceptance as a means of freeing up working capital, converting fixed costs to variable and gaining access to global best practices.

> Outsourcing deals in financial services and insurance services doubled in North America from the second quarter to the third in 2009, according to the Everest Group, an outsourcing consulting firm in Dallas[2]
>
> Datamonitor predicts that F&A BPO and Procurement BPO would grow at CAGR of 7.85% and 6.0% respectively for the next four years[3]
>
> Computer Economics states that the typical IT organization spends about 5% to 6% of its total IT budget on outsourcing services. This is true regardless of the organization's size.[4]

Companies are now evaluating and implementing organization wide business process outsourcing strategies, as opposed to pure departmental initiatives. Outsourcing is also being explored across the corporate value chain – from Accounting, Human Resource Management and IT to Procurement, Sales & Marketing and Product Development. Past concerns on data security and identity protection have been replaced by increasing confidence and comfort.

As procurers get smarter and more comfortable with the process, many recognize that while cost savings is essential for the short term, business agility and access to capabilities is the goal in the long run. Some leading procurers have demonstrated that process optimization helps accrue all potential benefits of outsourcing by enabling cost reduction, efficiency improvement and customer satisfaction. For example, an outsourced service provider's SSC in Curitiba (Southern Brazil) provides its client not only with financial benefits, but process improvement, business transformation and scalability to support their growth.

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[1] WSJ. Bharati Airtel to outsource more company operations. Wall Stree Journal. 9 November 2009. [Cited:11 November 2009] http://online.wsj.com/article/SB10001424052748704402404574525064035437316.html

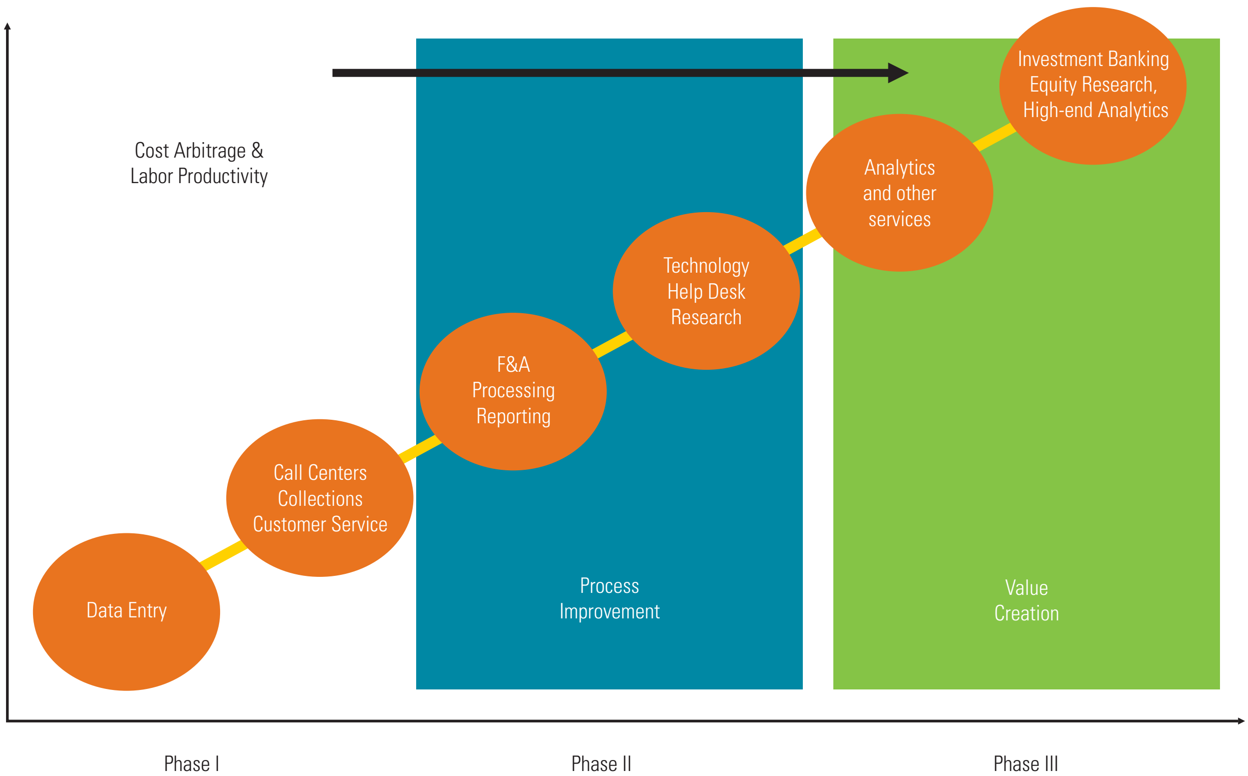
[2] Everest Group. North American financial sector contracts double over Q2, global outsourcing market drops 10 percent. Everest Group News & Events. [Online] Everst Group, 4 November 2009. [Cited: 11 November 2009.] http://www.everestresearchinstitute.com/News/10659.

[3] Datamonitor. Datamonitor's Global BPO Services Interactive Model. London : Datamonitor, 2009. Interactive Model. DM Product Code : IMTC0297.

[4] Computer Economics. IT Outsourcing Statistics. Irvine, CA : Computer Economics, 2009. p. 7, Sample Report .

With the primary focus of outsourcing initiatives being an immediate reduction in costs, many procurers are looking at reviewing and renegotiating contracts, scrutinizing billings and bringing-in greater emphasis on performance based rewards. Many procurers have also recognized the medium-to-long term benefits of process improvement and are proactively pushing their suppliers to undertake adoption of quality models such as CMMI and Six Sigma. These trends will likely be most acute for Phase 1 services that are essentially cost arbitrage and labour productivity improvement initiatives.

Evolution of outsourcing contract relationships



Stress on cost reduction, repeatability and quality. Will have to focus on shifting to lower cost regions for these services	Big players who can scale and offer financial stability will likely gain low-medium complexity work	Players who offer niche services will likely gain strength in high end KPO

Source: KPMG in India, Changing Landscape of IT–ITES Outsourcing, 2009.

> Today, we are less frightened about the crisis than a year ago, but still much uncertainty remains about what lies ahead

Stanley Fischer,
Governor, Bank of Israel
at President Shimon Peres's
Tomorrow Conference, Oct 2009[5]

3.2 Mitigating risk and uncertainty

Businesses have seldom seen levels of risk and uncertainty currently evident in markets. Consumers and businesses are holding back on purchases, unemployment in industrialized nations has risen and exchange rates are volatile. Globally dispersed suppliers and business expansion into emerging markets has complicated the job of corporate forecasters. In such uncertain times, businesses seek to reduce risk and uncertainty.

Datamonitor, in its Global BPO Services Forecast, predicts the global BPO market to grow at a compound rate of 5.65 percent annually between 2009 and 2013.[3]

Outsourcing of non-core shared services represents an opportunity to convert fixed labour costs into flexible supplier contracts. It has the added potential of improving internal customer service by bringing in international best practices and contracted service levels. Therefore, the demand for outsourcing services is expected to increase in the near future.

In a desire to reduce fixed costs and convert all expenses into variable costs reflecting business volumes, procurers increasingly favour third party service providers over captives. Many organizations that had set up offshore captive centres have now divested these ventures and outsourced the operations in order to release cash, improve liquidity and leverage the specialized experiences of service providers.

Most procurers are looking for partners who have the scale and adaptability to change based on changes in the procurer's business. Therefore, today's larger outsourcing arrangements consider a variety of sourcing models ranging from captive, outsourcing, hybrids, joint ventures, etc. in order to achieve long term benefits of aligned goals. Experienced procurers also seem to be pushing for more collaborative contracts where business metric drive performance measurement and there is greater risk-reward sharing.

Many procurers have also started to recognize additional sources of risks and uncertainty because of outsourcing. Many businesses have had to face suppliers becoming insolvent and/or business disruption due to force majeure events. The need for greater monitoring and risk management was highlighted by the recent admission of fraud by Satyam and the Mumbai terror attacks. Businesses therefore are increasing their focus on supplier risk assessment and mitigation strategies. Corporate governance models and business continuity plans seem to be stressed in supplier evaluations and a globally dispersed footprint is often seen as a de-risking measure. Many procurers can expect to invoke the right to audit clause more often and increase the scope of these audits.

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[5] Jerusalem Post. Uncertainity Reigns among business leaders. The Jerusalem Post. [Online] The Jerusalem Post, 23 Oct 2009. [Cited: 11 November 2009.]
http://www.jpost.com/servlet/Satellite?cid=1256150034097&pagename=JPost/JPArticle/ShowFull.

3.3 Leveraging global business needs

Evalueserve has four research centres located in Chile, China, India and Romania, covering multiple industries across every continent and in more than 50 languages.

Businesses are increasingly global in nature. An organization's offices, suppliers and customers might be stretched across multiple continents. Businesses today manage complex supply chains to meet client expectations and improve organizational efficiencies. Outsourcing vendors are increasingly being called to provide global solutions to meet the organisation's needs. Even organisations that do not have a global footprint are looking at offshore destinations to meet their cost targets and governance requirements.

While India and China remain the top offshore outsourcing destinations, alternative destinations are rapidly growing as global outsourcing hubs. KPMG International, in its 2009 report titled "**Exploring Global Frontiers"**, identified 31 such cities as "emerging" destinations. These cities offered multiple advantages vis-à-vis established markets in terms of lower costs, availability of qualified workforce, linguistic and cultural similarities, infrastructure, government support and tax incentives.

These alternative markets are expected to play a key role in the coming years especially since the USD 383 billion BPO industry is not restricted to high-cost economies or highly industrialized nations. Datamonitor in its Global BPO Services Interactive Model, Jan 2009 predicts that nearly 25 percent of this business is expected to be outside Western Europe, US and Japan. These economies represent significantly different challenges as compared to the United States or Europe. Access to global industry best practices and innovation appear to be the primary motivating factors as compared to labour arbitrage. However, cultural similarities and linguistic skills are equally important factors for these businesses to decide on an outsourcing partner.

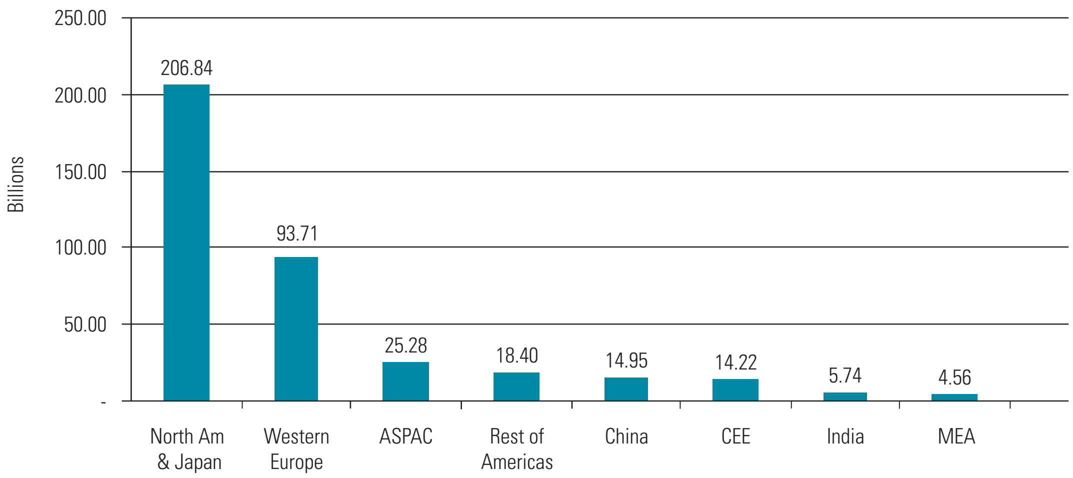
KPMG International in corporation with Economic Intelligence Unit published a survey based briefing paper **"Asian Outsourcing: the next wave"** in 2006 that identifies a wide acceptance of Outsourcing for varied business activities across Asian economies.[6]

Over the past five years, Bharti Airtel had signed around seven outsourcing deals, most of them with global IT major IBM. In 2009 Airtel outsourced provision of last mile connectivity and associated services in a deal estimated at USD 500 million to its joint venture with France's Alcatel-Lucent in an effort to lower costs. In 2004, Airtel awarded a USD 750-million outsourcing deal to IBM, which was later increased to USD 2.5 billion as of March 2009. In 2008, IBM's BPO arm IBM Daksh, bagged a six-year contract to provide voice and back-office services, including customer service from Bharti.[7]

[6] KPMG International. Asian Outsourcing : the next wave. Hong Kong : KPMG, 2006.

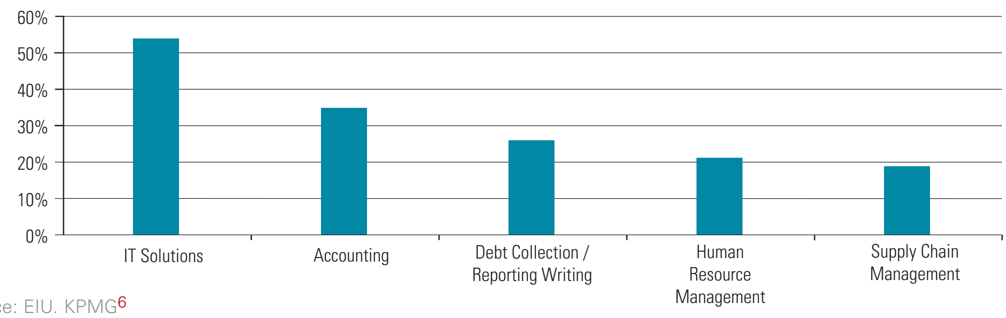
[7] Indiatimes. IBM Bags Bharati Airtel Outsourcing Deal . Infotec Indiatimes. [Online] Indiatimes, 10 April 2009. [Cited: 11 November 2009.] http://infotech.indiatimes.com/news/software-services/IBM-bags-Bharti-outsourcing-deal/articleshow/4385207.cms.

Global BPO Spend 2013



Source: Datamonitor. Datamonitor's Global BPO Services Interactive Model. London : Datamonitor, 2009. Interactive Model. DM Product Code : IMTC0297.

Asian Outsourcing



Source: EIU. KPMG[6]

Global IT Spend as per IDC, NASSCOM Strategic Review 2009

North America	Latin America	Western Europe	Central Europe and Africa	Asia Pacific
39% of the global IT services spend	3% of the global IT services spend	37% of the global IT services spend	4.7% of the global IT services spend	15% of the global IT services spend
4.2% growth in 2008	10% growth in 2008	5% growth in 2008	14.7% growth in 2008	6.8INR growth in 2008, over 10% in developing economies (excl. Japan)

4 Challenges for Service Providers

Outsourcing has seen modest growth in the past twelve months, but outsourcing service providers have not escaped the challenges that the broader economy has gone through. They too have had to face fierce competition for survival, increased pressures on margins and have had to adapt to a rapidly evolving business landscape.

4.1 Geographic diversification for growth & risk mitigation

Traditional models of providing shared services from a central hub are no longer viable. Many service providers have had to expand globally. Part of the growth has been to support dispersed procurer businesses. Other factors have been an effort to grow, de-risk and contain variability in revenue streams; address concerns of location risk; improve customer satisfaction by leveraging language skills and cultural affinity and reducing costs to improve the bottom line.

A majority of current outsourcing contracts are traditional Phase 1 BPO / ITO services, which are witnessing increasing pressures on margins. Providers have had to gain volumes in order to maintain profitability and will likely continue to look at scale and process improvement to keep these businesses viable. As the traditional outsourcing hubs become unviable locations for these services, providers may look at relocating them to lower cost cities across the globe.

WNS, spun off as a captive unit of British Airways PLC, has operations across the Philippines, Romania, Sri Lanka, the U.K. and the U.S. and its clients include UAL Corp.'s United Airlines and U.K. insurance giant Aviva PLC.[8]

Tata Consultancy Service has back office in Guadalajara, Mexico in addition to the 5,000 workers in Brazil, Chile and Uruguay.[9]

Cognizant Technology Solutions, with most of its operations in India, opened back offices in Phoenix and Shanghai.

In order to reduce variability in revenues and maintain bottom lines, many service providers have employed revenue diversification strategies that have included supporting more industry verticals, increasing service lines, moving up the value chain and expanding to targeting markets outside the US. In order to support these new markets cost effectively, providers have to access larger talent pools and are looking at alternate locations for employable workers. These locations also provide relief from the excessive levels of attrition that currently plagues the industry in the established hubs.

Many of the new service lines involve greater degree of customer interaction. Recognizing that language skills and cultural affinity are important parameters in ensuring success of such services, global diversification of operations has become imperative. Globalization also brings a degree of flexibility in staffing and 24/7 availability to service for service providers.

As indicated in KPMG International's **"Exploring Global Frontiers"** report of 2009, regions such as Latin America, Middle East and Eastern Europe are gaining popularity as alternative destinations as they provide a combination of factors that make them attractive.[10]

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8 Wall Stree Journal. WNS Expects Overall Net Margins to Stay Healthy. THOPPIL, DHANYA ANN. s.l. : Wall Stree Journal, 2009, Wall Stree Journal, p. 1.

9 TCS. TCS. TCS. [Online] 18 June 2009. [Cited: 10 November 2009.] http://www.tcs.com/news_events/press_releases/Pages/TCS-expands-Mexico-Global-Delivery-Center-Queretaro.aspx.

10 KPMG. Exploring Global Frontiers: KPMG, 2009.

4.2 Business metrics driven performance measurements

Business's expectations from IT and its outsourcing partners are changing fast, especially among corporate boards and decision makers. According to recent work by the Economist Intelligence Unit (EIU) **("Return on Technology : The economics of IT value creation", Information Age, 2008[11])**, senior managers are demanding closer alignment of IT to business goals to meet the competitive challenges. The research indicates that 69 percent of senior IT and business executives expect the primary role of IT, traditionally seen as cost efficiency, to be elevated to that of enabling revenue growth within the next few years. This expectation is most strongly held among CEOs and board members, 83 percent of whom are "wholly convinced" of this shift.

> USAA, a privately held bank and insurance company, introduced a check deposit feature using Apple's iPhone. Leveraging the phone's capabilities and recent check imaging legislature, USAA customers can directly deposit photographs of both sides of the check without having to physically deposit it at the bank - KPMG India Research

As businesses look at new ways to improve customer satisfaction and customer retention, business leaders can be expected to increasingly look at partnering with IT to create new value propositions. Today, IT's ability to reliably deliver day-to-day services such as Internet access, email and payroll no longer pass muster. Business leaders today are looking at IT to undertake initiatives that make tangible improvements to business performance if not introduce information- and technology-based disruptions to create a competitive advantage. Organizations are attempting to achieve such innovation by getting IT departments involved in business planning and revenue generation. Businesses are starting to place structures to foster close co-operation, understanding and communication between the business and its objectives and the related IT capabilities needed to deliver those, to ensure these goals are achieved.

IT is increasingly a large and strategic component of the overall cost base of many organizations. For many organizations, the economics of IT and the real value delivered continues to be a mystery. Additionally, some of the relationships that were first established by IT for application development and support have now mushroomed into full blown business process outsourcing relationships. Many CIO's are fast finding out that they are looking at

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[11] Information Age. Return on Technology : The economics of IT value creation. London : Information Age, 2008. The report was sponsored by KPMG UK.

responsibilities that stretch beyond managing IT or associated functions. The current operational performance measurements do not sufficiently focus on the business benefits being delivered by IT / ITES organizations. Therefore, internal IT organizations, and consequentially, captives and outsourced IT & ITES organizations are being increasingly measured based on tangible business benefits being delivered.

Captives previously had enjoyed multiple benefits and had little incentive to invest in performance improvement. As the economic conditions deteriorated, many of the captives have re-looked at their operations and evaluated their ability to grow and provide additional business value including converting into a profit centre and providing services to third parties. As businesses relook at the economics of such relationships, efforts to redefine their value proposition are expected to increase. Managers of captives may have to compete in an open market. We expect that captives that demonstrate bold initiatives, deepen relationships within their parent organization and provide tangible business benefits will continue to be afforded protection by the parent organization.

“Acquisitions are part of our strategy. We keep looking at it. The BPO space is likely to be the next engine of growth for the IT industry”

Suresh Vaswani,
Joint CEO, Wipro Technologies to Business Standard at the India Economic Summit.

4.3 Maturing Industry - Consolidation and Innovation

4.3.1 Consolidation

The need for scale: Traditional BPO and ITO services have become commoditized and are witnessing an increasing pressure on prices and margins. Many providers have had to gain volumes in order to maintain profitability. The current economic conditions have reduced firm valuations providing companies with strong balance sheets an opportunity to inorganically acquire new clients and capabilities. A recent Gartner report points out that one quarter of top BPO companies will not exist as separate entities by 2012.[12]

Promise of the captives: Many procurers who have invested in building captives are looking at unlocking the cash and are therefore providing service providers with attractive propositions. The “sale and contract back” of captives provides service providers with an opportunity to acquire specialized businesses with assured revenues from the parent. While service providers seem to have hoped to utilize the specialized knowledge of these captives to service procurers in the same industry, the rate of success on such ventures is yet to be conclusively determined.

[12] Kaur, Gagandeep. Consolidation Times. Voice & Data - CIOL. [Online] 2 November 2009. [Cited: 10 November 2009.] http://voicendata.ciol.com/content/NetworkingPlus/109110202.asp.

Assimilating the small, agile and innovative: Drawn to the success of traditional outsourcing providers, a host of providers with specialized skills and domain knowledge have expanded the boundaries of outsourcing. They have eschewed the simple and fairly boxed out processes in favour of using special skills and having high levels of customer interactions. Legal Services, Investment Research, Sales & Marketing and Product Development are the new frontiers in outsourcing. Smaller service providers have proven to be more agile and responsive in meeting procurer needs. With lower degrees of employee churn and higher customer satisfaction, these providers have been rewarded with healthy revenue streams and margins. We see a symbiotic relationship that would drive greater acquisitions - larger player's attempts to diversify revenue streams and smaller players need for stability and credibility of a large balance sheet.

We believe that acquisitions will remain an important driver in the industry. Smaller organizations would do well to consider an active strategy of bulking up, partnering with or being acquired by larger players. The market will likely outgrow from supporting specialized providers to large players that can offer a wide variety of services to procurers.

4.3.2 Innovation

Cloud Computing

The success of cloud based delivery models like Google Docs and Salesforce.com has sparked an interest in cloud computing within the enterprise. Organizations like Microsoft, IBM, SAP, Infosys and Wipro are trying to establish cloud based business models that would service both SME's and Large Enterprises. These services include some flavours of Infrastructure Utility, Software as a Service and Platform BPO. In their Oct 2009 Report "Capturing the value of cloud computing", BCG estimate that the enterprise cloud computing market will likely be USD 60 - USD 80 million within the next three years.[13]

Cloud computing is the deployment of IT resources like processing power, storage and applications over a wide area network (WAN) leveraging abundant bandwidth and common system architecture. Its promises are the ability to avoid capital expenditure, pay-per-use and faster deployment. Concerns remain about pricing, availability guarantees and security of services offered, but there is a greater interest among purchasers to experiment with such newer models.

[13] BCG. Capturing the value of cloud computing. Munich and London: BCG, 2009.

A shift by a significant number of customers from licensing software to outsourcing processing tasks is holding down Jack Henry & Associates Inc.'s revenue growth.

The core processing software and services provider said its fiscal fourth-quarter licensing revenue fell 25 percent from a year earlier, to USD 18.3 million. During its most recent fiscal year, 27 banks switched from in-house processing to Jack Henry's outsourcing services, the vendor said, including 14 that switched in its fourth quarter.[14]

Proven Models: Infrastructure Utility and Software as a Service (SaaS)

The availability of processing power, storage and network capacity without the requisite capital expenditure or time to deployment have been a reality with shared data centres and hosting solutions. A recent Gartner Report pegs the Managed Services growth at a CAGR of 25 percent Worldwide. India has a share of USD 4 Billion in entire pie and is expected to grow at a CAGR of 23.8 percent. A deal worth GBP 50 million between Land Registry and Steria, another USD 12 Million between Patni Computer Systems and BUPA suggest that the Managed Services activity might just be heating up. On the global front, news like General Atlantic investing USD 150 Million in Quality Technology Services and Equinix acquiring Switch and Data support the growth story in Managed Services.[15]

Ability to provide Software as a Service (SaaS) is comparatively a new offering. Corporate E-mail was among the first services to be successfully outsourced and managed by service providers. Salesforce.com demonstrated the viability of expanding the model to other business areas. The model has gained popularity among financial services firms for their core processing engine, especially in the United States and Germany.

Evolving Model: Platform BPO

Businesses have grown into or acquired complex IT assets and outsourcing relationships that have become cumbersome and hamper seamless delivery of services. Some service providers are addressing this challenge by taking on complete ownership of the people, processes and technology required to meet the purchaser's business objectives. By requiring procurers to adopt a standard platform they seek to guarantee service level agreements and measurement by standard business metrics.

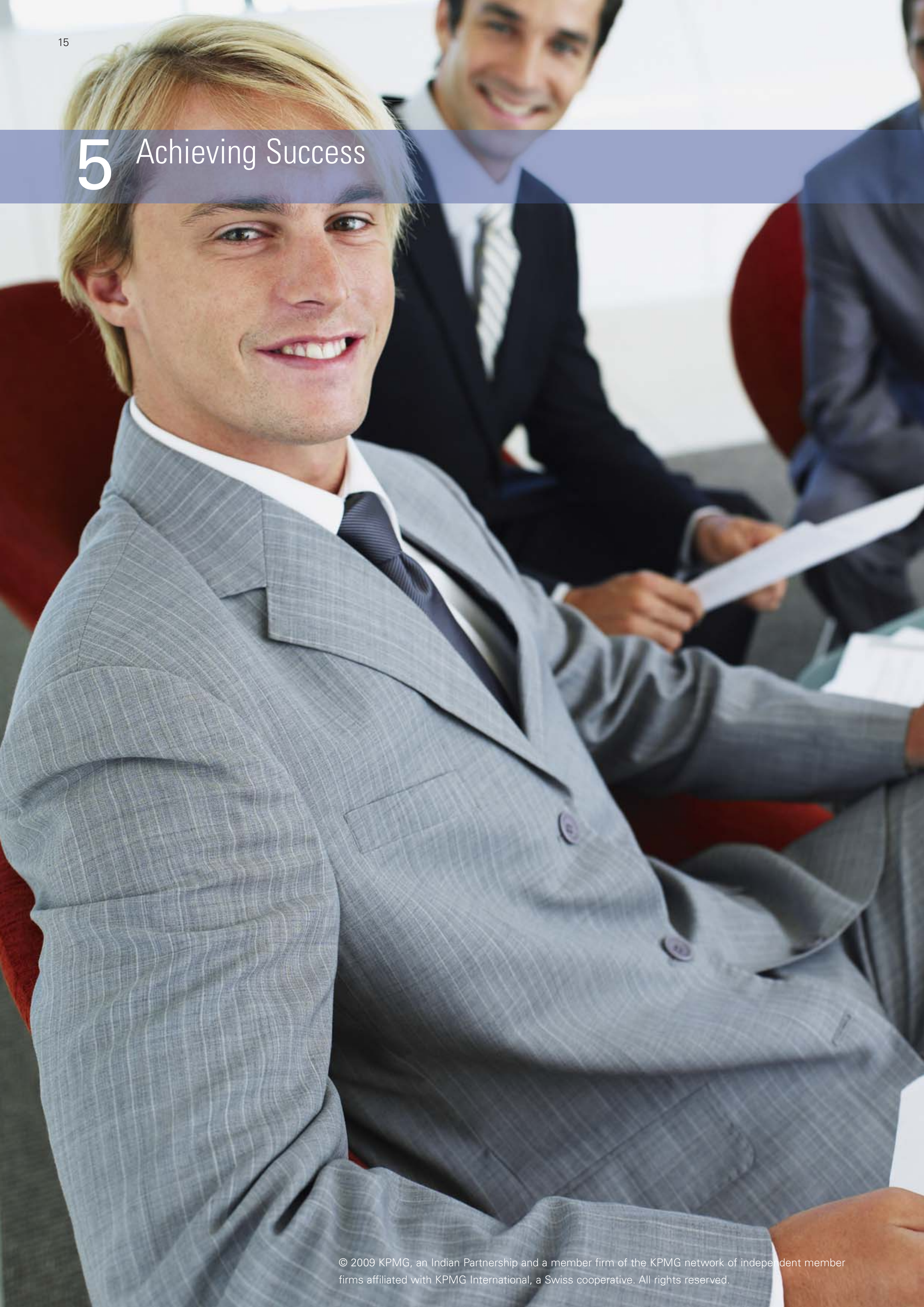
Establishing such integrated services has high barriers to entry. It requires the service provider to deliver using skills across IT systems management, process execution, and business domain expertise. With the evolution of business analytics, some providers might soon provide advanced metrics and KPI's while seamlessly managing the complexity to arrive at those metrics. Despite its challenges, it addresses few key concerns of procurers and promises to provide IT/ITES service provider a large moat to protect them from competition and the opportunity to command a premium.

The growth of such offerings is a crucial step in building transformational relationships, enabling the service provider to act as an internal member of the purchasers firm.

[14] American Banker. Outsourcing Trend Takes a Bite Out of Jack Henry. Monett, Missouri, United States: s.n., 21 August 2009.

[15] CIOL. Third Party Data Centers on growth. CIOL. [Online] CIOL, 28 October 2009. [Cited: 11 November 2009.] http://www.ciol.com/Enterprise/News-Reports/Third-party-data-center-on-growthFS/281009126958/0/.

5 Achieving Success



5.1 Going back to basics in outsourcing

As outsourcing veterans would likely corroborate, outsourcing is less about the deal and more about making the relationship work. Therefore procurers would do well to re-examine the basics of choosing a partner.

Some questions to ask:

Why are we outsourcing? Is the business goal to save money, improve operations or boost business performance? Efficiency focuses on cost improvement; Enhancement focuses on operational improvement; Transformation focuses on business performance improvement.

What services and functions should we consider to meet those goals? Across the enterprise, what services or processes are candidates for a sourcing review?

Who can best perform or deliver these services to meet those goals? Should the job be performed in-house or outsourced to external resources?

How should the work be done? Do we want a customized or standard service/process?

Where should the work be done? Will this work be performed domestically/onshore or non-domestically/offshore?

5.2 The need for continuous review

For an outsourcing engagement to succeed, the concerned parties must be on the same page. Assuming that once outsourced, the service provider assumes responsibility for ensuring success of the engagement, is a wrong notion.

Traditional systems in vendor sites look at collecting satisfaction feedback from the procurer at the end of the engagement or during the course of the engagement. It is usually a one way exercise wherein the procurer provides feedback on areas of improvement. Similarly project closure reviews by the vendor usually focus on interaction challenges with the procurer during the engagement. Rarely does the outcome of these surveys cross the divide between service provider and procurer. The wide acceptance of Supply side/vendor maturity models helped improve supplier efficiencies. The evolution of Demand Side/Outsourcer models could help in bridging the gap that currently exists.

Having witnessed such challenges, we believe that touch-points between procurers and vendors have to be carefully examined with a view of identifying potential areas that could pose a risk in the future. Correlation analysis of parameters that indicate vendor efficiency and tying them to the operational parameters in the client side could help establish systems and improve processes related to client-vendor relationship.

For example, it might help correlate degree of change in requirements introduced by the business requirements team and the post release defects found by the acceptance team. This could help understand the flexibility of change management and improve the requirement management process on both sides. Attrition analysis with respect to available domain expertise could provide advance warning to either gear up for training or to ask the service providers to take proactive steps to reduce attrition of key skills. In an era of multi-vendor sourcing, reviews could be enhanced with an element of benchmarking amongst vendors.

We should understand that the review cannot be a onetime exercise. Reviews have to be a continuous exercise, helping both organizations understand and address interaction concerns. Procurers usually question the wisdom of investing energy and cost in bringing up vendors when they could easily change relationships and procure services from a better vendor. The answer lies in understanding that outsourcing relationship add more value to the procurer as the service provider's familiarity with its (procurer's) people and business processes increase. As vendors take time to mature during a relationship, bringing in value addition and savings, the client also needs to undertake additional efforts to add to the relationship.

Instead of the 10 year fixed contracts in the past, contract re-negotiations are happening on a yearly basis which gives better control over the vendor as well as pushes the procurer client to demonstrate improvements/gains by the sourcing relationship with it. Third party reviews by a capable multidisciplinary team of professionals (covering People, Process, & Risk perspectives) and members from the procurers sourcing team help reduce the cost of such reviews as compared to building up a team internally. Care should be taken that the reviews do not get restricted to Contract Compliance.

5.3 Evolution of contract models for tomorrow

In the context of harsh economic conditions, firms should use IT as a strategic advantage, the goal which further percolates to the IT Service Providers / Off shoring firms. Service providers should thus mature their contracting models from the traditional service level based contracts to more risk taking ones. An important key to success is working with customers, understanding their business and sharing the fruits of success from both sides.

Evolved Models

5.3.1 Conventional

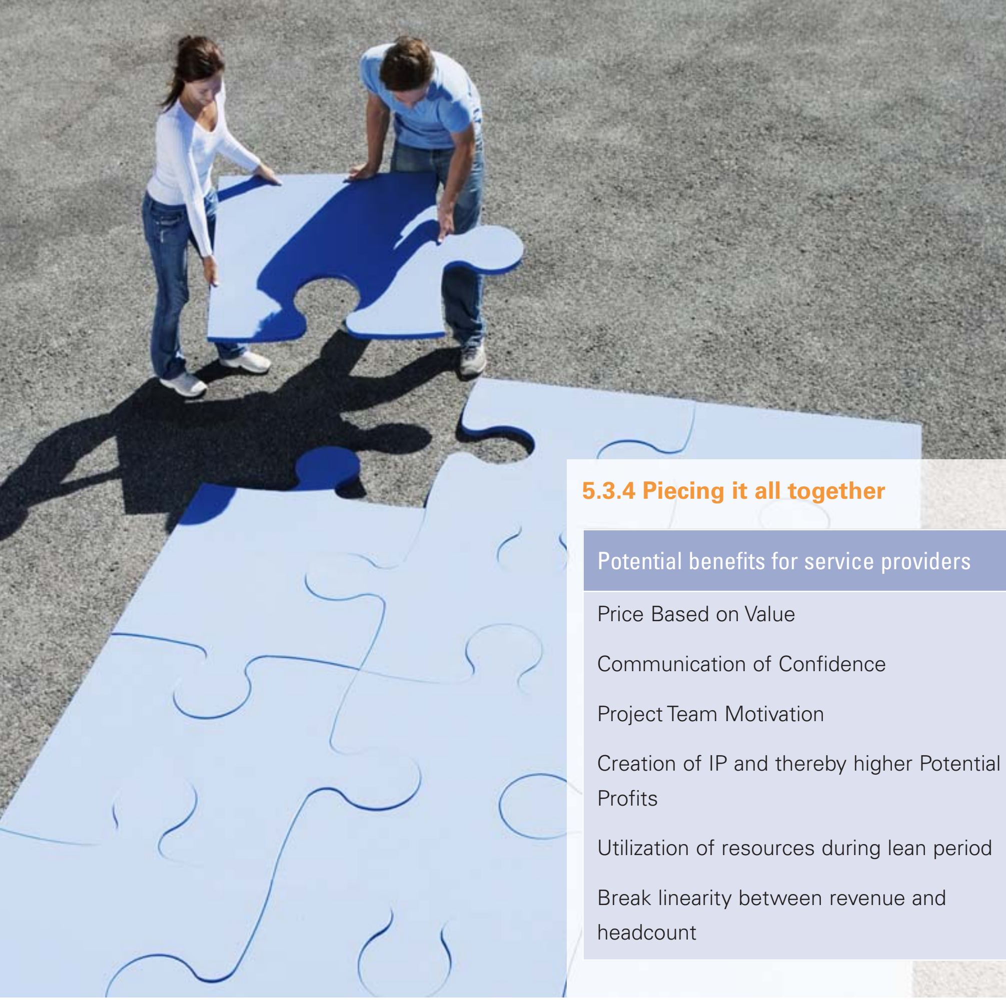
- The most obvious way of measuring performance for the purposes of service bonuses is against defined service levels
- The Service Provider could, for example, be rewarded with extra incentive if its performance in certain key measures over a defined period of time puts it in the top quartile of industry performance in that particular set of metrics

5.3.2 Collaborative

- More successful risk and reward mechanisms tend to focus on output metrics rather than input metrics. So, instead of focusing on traditional input service levels such as system uptime, it may be more appropriate to measure the number of orders or processes handled by the system in a particular measurement period
- Gain Sharing is one the most commonly discussed methods of implementing risk / reward. Under a collaborative gain sharing, the customer may agree to make a bonus payment if the outsourcing helps the customer to achieve pre-defined cost savings. Alternatively, the parties may agree to share any increased revenue or profit generated by the improved outsourced services.

5.3.3 Transformational

- Transformational Risk and Reward mechanisms take the collaborative approach to the next level. They measure the success of major transformational projects and align incentives with enterprise level outcomes such as market share or return on capital. The transformation might include the development of a new platform to support a new line of business or product. If a transformational project involved a significant new software development, as well as sharing in any increased revenue or cost savings associated with transformational project, the parties may agree on a mechanism to jointly exploit the intellectual property created as part of the Project.
- Gain sharing in this context can only be effective if both parties understand their responsibilities for realizing the benefits of an IT Services Implementation. It also should be possible to quantify the benefits that might be derived from a particular implementation. This can be done either by agreeing on the extent of the cost reduction up-front at the preliminary design stage, identifying the cost that the project should affect or using agreed mechanisms to quantify the benefits. Therefore, it is necessary to agree on the basis of which gains will be shared, likely using some sort of banding arrangement.



5.3.4 Piecing it all together

Potential benefits for service providers	Potential concerns of service providers
Price Based on Value	Large Deals
Communication of Confidence	Investment in Domain
Project Team Motivation	Investment in Resources to develop IP
Creation of IP and thereby higher Potential Profits	Contract Development
Utilization of resources during lean period	
Break linearity between revenue and headcount	

Potential benefits for procurers	Suggested guidelines for procurers
Reduced Risks	Supplier to be given enough control to be successful
Aligned Objectives	Communicate Project briefs continually
Payments tied to Results	Review metrics regularly
	Share data freely
	Don’t be over legalistic

5.3.5 Summary

- Good risk/reward contracts tend to be highly specialized and require careful and creative management
- Formulating such contracts requires a sound understanding of customer’s business and willingness on customer’s side to invest on management effort for definition of Risk & Reward models and governance mechanisms
- The creation of IPs and ownership issues should be studied and professionally managed

6 Conclusion

It is about cost reduction: Outsourcing is about reducing operating costs. In all its forms, procurers tend to look at outsourcing because it offers the ability to do tasks cheaper, faster and with similar quality. Even for Phase 3 Value Creation Services, the emphasis is on Return on Investment. Many procurers look to service providers to proactively reduce costs and are actively enforcing performance improvement initiatives to drive transaction costs down.

Size does matter: Stronger balance sheets, a healthy pipeline of orders and breadth of services are all important considerations in an outsourcing partnership. Procurers need to know that service providers will likely remain viable businesses, at least during the validity of the contract. Size and volumes also play an important role in determining service provider profitability, especially in markets that are commoditized. The current levels of business uncertainty make this a difficult decision to make in terms of smaller providers. Service providers should actively look at opportunities to increase business volumes.

Invest in process improvement: Long term cost reduction is only possible by constantly innovating and improving processes. Many procurers see value in establishing a culture of process improvements and how they redefine the cost – risk – efficiency equilibrium. Many service providers seem to recognize that margin improvement can only come by investment into new technologies or improvement of business processes.

Go-Global: Single location cannot offer service providers or procurers a long term advantage. From a business development perspective, outsourcing is growing faster in Asia and Latin America than in developed nations. From a services delivery perspective, tax structure and other government incentives can play a major role in the profitability of the outsourcing venture. A global outlook to acquire clients and set up service locations can be beneficial. It can help reduce operational risk and has the potential to increase customer satisfaction.

Innovate: The IT organization of tomorrow is going to be very different. There is a growing movement towards business metric based performance evaluation of IT functions. Business users expect the convenience of consumer technologies within corporate environments. Business decision and execution cycles are shortening, and there is a growing demand for IT on-demand. IT/ITES service providers need to be on the alert for changes in their marketplace and proactively build strategies for evolving business models.

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7 About KPMG in India

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 140 countries and have 135,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International, a Swiss cooperative. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

The Indian member firms affiliated with KPMG International were established in September 1993. As members of a cohesive business unit they respond to a client service environment by leveraging the resources of a global network of firms, providing detailed knowledge of local laws, regulations, markets and competition. We provide services to over 2,000 international and national clients, in India. KPMG has offices in India in Mumbai, Delhi, Bangalore, Chennai, Hyderabad, Kolkata, Pune and Kochi. The firms in India have access to more than 3,000 Indian and expatriate professionals, many of whom are internationally trained. We strive to provide rapid, performance-based, industry-focused and technology-enabled services, which reflect a shared knowledge of global and local industries and our experience of the Indian business environment.

8 About CII

The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the growth of industry in India, partnering industry and government alike through advisory and consultative processes.

CII is a non-government, not-for-profit, industry led and industry managed organization, playing a proactive role in India's development process. Founded over 114 years ago, it is India's premier business association, with a direct membership of over 7,800 organizations from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 90,000 companies from around 385 national and regional sectoral associations.

CII catalyses change by working closely with government on policy issues, enhancing efficiency, competitiveness and expanding business opportunities for industry through a range of specialized services and global linkages. It also provides a platform for sectoral consensus building and networking. Major emphasis is laid on projecting a positive image of business, assisting industry to identify and execute corporate citizenship programmes. Partnerships with over 120 NGOs across the country carry forward our initiatives in integrated and inclusive development, which include health, education, livelihood, diversity management, skill development and water, to name a few.

Complementing this vision, CII's theme for 2009-10 is 'India@75: Economy, Infrastructure and Governance.' Within the overarching agenda to facilitate India's transformation into an economically vital, technologically innovative, socially and ethically vibrant global leader by year 2022, CII's focus this year is on revival of the Economy, fast tracking Infrastructure and improved Governance. With 64 offices in India, 9 overseas in Australia, Austria, China, France, Germany, Japan, Singapore, UK, and USA, and institutional partnerships with 213 counterpart organizations in 88 countries, CII serves as a reference point for Indian industry and the international business community.

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