

The Changing World of Outsourcing

Neal Leavitt

Outsourcing—a practice once considered controversial—has become widespread, not only with technology companies but also with the IT departments of firms in other industries.

The volume of tech *offshore outsourcing*—in which companies in economically advanced countries send work to businesses in developing nations—has increased since the approach became popular during the economic boom of the mid 1990s. During that time, the nature of the practice stayed largely the same.

Now, though, this appears to be changing.

For example, companies that handle outsourcing are beginning to consolidate, creating larger providers offering a broader range of services. At the same time, niche providers are emerging.

In addition, countries such as China are beginning to compete with India, the longtime outsourcing-services leader.

Once, large companies did most tech outsourcing. Now, smaller and mid-size companies are beginning to outsource work. Also, companies primarily used to outsource large projects, such as basic application development or call-center operations. Now, as outsourcing becomes more widespread, businesses are starting to contract out smaller



projects—including complex scientific and R&D projects—to more and more providers.

Various technical and marketplace developments have driven and enabled these changes. And industry observers expect more changes in the long run.

INSIDE OUTSOURCING

Technology-related outsourcing began in the early 1980s and grew rapidly in the mid-1990s. The driving forces included the expanding tech economy, increased pressure on IT departments to do more with their resources, the increasing complexity of managing IT and keeping up with rapidly advancing technologies, and the difficulty in finding IT workers in all skill areas, noted David Parker, vice president of IBM Global Technology Services' Strategic Outsourcing operations.

Since then, companies have outsourced more than just IT functions. For example, they have used the approach to make their production, customer service, and other processes

efficient and inexpensive by farming them out to businesses that have the necessary expertise and can perform them less expensively, Parker noted. This work includes help desk, data center, and network management operations; database administration; and server management.

There are outsourcing providers in both economically advanced and developing countries. The latter are able to offer lower costs because workers there receive lower wages.

Offshore outsourcing has become controversial, especially in the US, where critics say it is a way for domestic companies to save money by taking jobs from local workers and moving them overseas.

SHORT-TERM TRENDS

Technology has helped change the face of outsourcing. For example, improvements in telecommunications and Internet-based technologies such as videoconferencing, instant messaging, and Internet telephony make communication faster and more widely available for outsourcing providers and their clients, noted Alex Golod, vice president of business development for Intetics, a global software-development company.

Legal issues are also important. Some businesses in developed nations are outsourcing work to overseas branches of domestic companies to have more legal recourse if problems occur, said Ashish Gupta, CEO of Evalueserve Business Research, a market-analysis firm.

Consolidation

Because more companies are farming out a greater variety of projects, there has been a proliferation of outsourcing suppliers in recent years to meet the demand.

Meanwhile, as outsourcing companies have grown, they have looked for ways to reinvest profits, expand, and acquire new capabilities, noted Gupta.

For these reasons, outsourcing is experiencing a number of mergers and acquisitions.

For instance, the US-based EPAM Systems became the largest software-engineering-services provider in Central and Eastern Europe by acquiring Vested Development, a Russian software-development-services firm.

India's Wipro acquired Infocrossing, a US infrastructure-management services provider, for \$600 million. Wipro has since opened several software-development and IT-services offices in the US.

Among other recent outsourcing deals, IBM purchased Daksh, Computer Sciences Corp. bought Covansys, and Electronic Data Systems acquired Mphasis.

According to Intetics' Golod, consolidation is a way for small and mid-size vendors to survive and grow while gaining efficiencies in marketing and operations, and for larger companies to acquire competitors and firms with niche skills.

Beyond India

India has been the leader in outsourcing services since the mid-1990s, mostly because it has a large, educated, English-speaking tech workforce; low salaries; and a technology sector that has pursued the work for many years.

Market-research firm Gartner Inc. warns that a shortage of tech workers and rising wages could erode as much as 45 percent of India's market share by next year. In addition, Indian outsourcers can't handle the high volume of available projects.

According to Intetics' Golod, competition is coming largely from places such as China, the Philippines, Eastern Europe, Latin America, and even developed countries like Ireland and Israel, as discussed in the sidebar "Developing Countries Join the Outsourcing Marketplace."

Market-research firm IDC predicts that China will overtake India by 2011.

Emerging low-wage countries that may also pull business from India over the next few years include Egypt, Malaysia, Pakistan, and Thailand.

Small-scale and niche outsourcing

Traditionally, outsourcing has entailed big companies and large, long-term projects such as major application development or the operations of entire departments. Bigger companies have been more willing to pay for outsourcing than smaller ones, have had more tasks they could offload, and could provide larger contracts than smaller businesses.

Now, though, more companies are competing with large outsourcing providers. This includes outsourcing providers targeting smaller businesses and smaller, shorter-term jobs—including minor testing and business-analysis projects—either to

Developing Countries Join the Outsourcing Marketplace

India has been the leading offshore technology-outsourcing supplier for a decade. The country has leveraged several advantages, including low salaries and a big, English-speaking workforce with college degrees in technology fields.

However, there have been growing opportunities for other developing countries to enter the outsourcing-services market. For example, there is more outsourcing work than India can handle. In addition, wages in India are rising. And companies in other countries are actively pursuing and promoting their services.

China

This country attracts outsourcing projects largely in areas such as low-end, PC-based application development, quality-assurance testing, system integration, data processing, and product development. India is even outsourcing work to China.

Market-research firm IDC's Global Delivery Index—which ranks locations according to criteria such as available skills, political risk, and labor costs—said Chinese cities have made significant investments in infrastructure, English-language instruction, and Internet-connection availability.

The country has undergone a massive telecommunica-

tions expansion as a result of national economic policy.

Also, China is producing 400,000 college graduates in technology fields annually, said Kenneth Wong, managing partner at SmithWong Associates, a China-focused US consulting firm.

"Language issues are no longer the major handicap to China-based outsourcing," noted Wong. "Many IT personnel in China today are US-educated. The Chinese government knows it has a way to go in reaching English-proficiency parity with India, but the signs are encouraging."

Paul Schmidt, a partner with outsourcing consultancy TPI, added that demand for the country's outsourcing services is driven largely by multinational corporations looking for access to China's domestic market and a presence in the rest of the Asia-Pacific region.

Russia

Russia's principal outsourcing competencies include Internet programming, Web design, and Web-server and Web-database application development.

The country has an educated, experienced labor force, with the world's third-largest pool of engineers and scientists per capita. English competency is good for mid- to higher-level managers and acceptable for

capture a market niche or to expand their customer base. This work can entail either parts of larger jobs or small, individual projects.

To remain competitive, the larger providers are also looking at the smaller end of the outsourcing market, in part by standardizing their offerings to make them less expensive, noted Parker.

Outsourcing consultancy TPI says the number of commercial outsourcing contracts of more than \$50 million, especially in the US, has declined.

According to TPI, many Indian providers are seeking smaller jobs than in the past and thus are expected to increase revenue from North American companies by 37 percent during the next two years, even though the region is outsourcing less work.

Niche outsourcing providers are well placed for the smaller contracts—often for more-focused projects—that are becoming more

popular, said Peter Allen, TPI partner and managing director of marketing development.

The growth of niche outsourcing is contributing to multisourcing, in which companies farm out different parts of a project to multiple specialty service providers, said Brian C. Daly, public relations director for Unisys' outsourcing business.

"This makes it possible to choose best-of-breed outsourcing firms to handle different tasks and to optimize costs," noted Intetics' Golod.

Outsourcing new and more complex tasks

As outsourcers have gained more skills, companies are beginning to farm out more-difficult technology tasks. Banks and other businesses, for instance, are moving well beyond outsourcing low-level application-maintenance work and are increasingly relying on offshore providers for help with full-system projects.

These include providing online banking capabilities, customizing enterprise-resource-planning systems, or conducting statistical and actuarial projects for insurance firms.

Outsourcing the modernization of legacy applications is another area with significant potential. This would help, for example, companies that no longer have the in-house expertise to work with older applications written in languages such as Cobol and that don't want to spend the time and money necessary to rewrite them in other languages.

Cost not the only factor

Companies are farming out work not only to save money but also to gain long-term access to outsourcing firms' talent, as well as their innovative, creative, and advanced approaches, said Unisys' Daly.

Many companies find recruiting to be a tedious and expensive

developers who communicate directly with clients, noted Alex Golod, vice president of business development for Intetics, a global software-development company.

Eastern Europe

Countries such as Belarus, Bulgaria, the Czech Republic, Hungary, Poland, Romania, and Ukraine specialize largely in application development, particularly for complex scientific projects or commercial products. The region has a solid educational base, producing qualified scientists and engineers, explained Golod. Also, he said, the workers in these companies prefer complex, challenging projects to simple coding.

In addition, larger clients are interested in sending work to Eastern Europe because they want to diversify their outsourcing across geographic regions.

Eastern Europe gets a lot of projects from Western Europe and the UK, which are in nearby time zones, as well as the US, he said.

Latin America

Countries in this region—particularly Argentina, Brazil, and Mexico—specialize in outsourcing projects such as application development. They have the

advantage of time-zone proximity to the US. This makes Latin America ideal for time-sensitive projects and work where the outsourcer must communicate quickly and regularly with the outsourcing company.

Philippines

This nation has a large English-speaking population and is carving out a niche for call-center operations. Evaluate Business Research, a market-analysis firm, reports that favorable factors include a 94 percent literacy rate, a high-quality telecommunications infrastructure, familiarity with Western corporate culture, and government initiatives such as exemptions from license fees and export taxes that have stimulated outsourcing growth. Also, wages are low.

Developed countries

Ireland has a favorable IT services infrastructure and is strong in software development and testing. Israeli outsourcing providers specialize in commercial software development, particularly security and antivirus products. Although both nations have higher labor costs than developing countries, they continue to attract business because of their well-educated workforces and stable governments.

process, with choices often limited by local manpower resources, added Rob Enderle, president and principal analyst with the Enderle Group, a market-research firm. Global outsourcing firms have access to extensive pools of talent and well-established recruiting procedures.

Industry observers expect offshore outsourcing to continue growing. For example, Forrester Research, a market-analysis firm, estimates that software outsourcing will account for 28 percent of IT budgets in the US and Europe by 2009, up from 20 percent in 2006.

Forrester also predicts that the number of overseas software developers working on projects for firms in developed countries will rise from 360,000 this year to about 1 million by 2009.

Companies will increasingly outsource telecommunications- and Internet-based development because the technologies in these areas are based on international standards and are thus easy for offshore vendors to work on.

Security is a big concern for many companies, with the growing use of mobile technology and the increasing complexity of threats. More companies will thus outsource short-term and ongoing security efforts, as keeping up with the work themselves will require too much time and money.

However, there may be a limit on growth prospects, Golod said. For example, he noted, international political and economic problems could reduce the amount of outsourced work.

According to Enderle, outsourcers may face problems coordinating their work with customers as they

take on a greater variety and number of clients and projects.

And, said Renga Rajan, technical director for Fast Pvt. Ltd. (www.fastindia.com), an Indian outsourcing supplier, providers will face challenges keeping their prices down because of rising salaries for skilled workers in developing countries. ■

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