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Top Ten Trends in Services Globalization 2009



The tsunami of the global economic downturn continues to impact the foundation of the outsourcing industry both near and long-term.

Service providers are already feeling the effects of decreased margins and employee downsizing, while service buyers are reducing IT budget allocations for outsourcing engagements. This in turn has caused a cascading effect across the industry - evidenced by drying pipelines, cancelled bookings and increased pressure to deliver value beyond cost.

Despite this lingering cloud of uncertainty, Tholons predicts a strong demand for outsourcing over the mid to long term.

The current turbulent conditions are expected to produce a stronger, more efficient outsourcing industry.

According to Avinash Vashistha, Global Managing Partner & CEO at Tholons, *“Service buyers will need to re-assess their outsourcing strategies and implement a better mix of multi-sourcing, combining nearshore and offshore models, while service providers will look to tap growing domestic markets (such as China, India, Argentina, Brazil and even the US) as a means to hedge against the volatility of existing offshore contracts.”*

Decreasing margins and headcount will push providers to better utilize existing resources. Service providers need to implement new technologies in a more efficient manner to differentiate themselves and improve service delivery processes. Clients, with reduced IT budgets, will be forced to be more selective – demanding far more stringent SLAs, greater contractual flexibility and output / result based payment schemes.

These shifts will significantly induce a high degree of consolidation that will be felt across the outsourcing ecosystem. **Paul Santos, Managing Director at Tholons Capital says:** *“It’s an opportune time for the larger players to continue their string of strategic, niche acquisitions. In an increasingly competitive market, and unpredictable economic state, the mantra of only the strong will survive has never been more relevant.”* Smaller and less efficient providers may face difficulties in tapping new revenue streams and will be prone to acquisition or outright dissolution.

Undeniably, 2008 was a tumultuous year for outsourcing, and though we continue to advise clients to remain cautious in the year ahead, we do not discount the opportunities and potential still very much evident in the market. We consider the current struggles of the industry as a driver for positive change and expect the outsourcing industry to develop in the coming years – more mature, efficient, dynamic, and ultimately more resilient. With prudence, heightened focus, and a more adaptive approach towards outsourcing – 2009 can in fact be a watershed moment for the global outsourcing industry.



Tholons Top Ten Trends in Services Globalization – 2009 will have a significant impact on Global Outsourcing for buyers, investors, providers and on emerging centers of excellence:

1) The market downturn will impact revenues during the first 2-3 quarters.

There are strong headwinds for vendors in the outsourcing space. We expect the worldwide market downturn to impact growth and margins for the first 2-3 quarters of 2009 before picking up and ending the year on a stronger note as clients seek to cut costs and generate more revenues. During this period, we see a reduced

number of start-ups in the services sector as the focus shifts to sponsoring hard asset-intensive businesses. Moreover, it has become increasingly clear that the downturn is impacting revenues and we expect most large firms will see a decline in QoQ earnings.

2) Focus on domestic market to increase.

As Western economies continue to hurt, service providers will shift their focus to domestic markets for growth. We are already seeing increased focus by vendors towards large (and growing) domestic markets such as found in India, China, Argentina and Brazil. Fulfillment of customer support and back office services targeted for retail, telco, and financial services

verticals will be amongst the hot spots for providers looking to tap the surging local demand of outsourced services.

Allen Kilgore, Principal at Tholons adds, *“The US domestic market will see an increase in domestic sourcing to take advantage of the available talent pool at an attractive cost with incentives by local government.”*



3) Global economic downturn will lead to increased outsourcing in Healthcare, Education, Retail, Telecom and Legal Process Outsourcing (LPO).

The global economic downturn is motivating service providers to focus on recession proof industries like Healthcare and education. *“The healthcare industry globally has been a good adopter of global outsourcing in the last couple of years and we see this trend continuing on a steep curve as we look towards 2015,” says Dr. Garima Vashistha, President - Healthcare at Tholons.*

Other sectors like manufacturing, retail and telecom will have to make a significant shift and reduce cost drastically to survive. These sectors will be attractive industries as they look for opportunities to cut cost. It is more a question of survival than being just competitive in such turbulent times.

Consolidation in the financial sector is inevitable due to the global financial crisis. This will create

M&A opportunities which will generate further business for LPO firms. We expect strong growth for LPO firms. Increased M&A activity in the financial sector would also mean that merging companies would want to integrate their existing outsourced services – leading to an increase in spending for integration projects. The processes will revolve around integration of software applications, data center consolidation and tighter integration of other operational platforms.

With financial institutions such as Lloyds TSB/HBOS and Bank of America/Merrill Lynch merging, service providers will also find themselves bidding against incumbent transnational rivals like IBM, Accenture and HP-EDS for several large-scale integration contracts (valued anywhere between US\$500 million and US\$1 Billion over 5 years).

4) Governments to take special initiatives in promoting destinations.

Emerging outsourcing destinations still trying to establish their brands will find the going tough, as clients look for “safer” choices. *According to Manuel Ravago, Head of Research at Tholons, “Centers of excellence are emerging with “cities” being the focus as clients search for cost effective quality talent pools. We anticipate governments will assume a more crucial role in promoting some destinations by developing work force capacity, infrastructure and effective*

regulatory / trade policies that are favorable to outsourcing.”

Cebu City, Shanghai, Beijing, Ho Chi Minh City and Krakow make up the top five spot in the recent Tholons study of Top 50 emerging global outsourcing cities. We see significant government and industry support for these cities along with some other more popular emerging destinations like Cairo, Sao Paulo, Buenos Aires and Dalian.



5) Clients will increase geographic diversity in their service delivery locations.

Newer service delivery geographies are emerging with niche capabilities. *“The Philippines has exhibited spectacular growth, with BPO export value aggregating close to 50% of India’s Business Process Outsourcing (BPO) export,” says Jo-An Darlene Chua, Country Manager - Philippines at Tholons.* Similarly, Vietnam has emerged as a solid alternative to India on the IT side, and we are seeing aggressive strategies from Vietnam-based players to increase traction in the global market. In the coming year, we will see more clients asking for alternatives to India to *de-risk* their

service delivery models that are otherwise geographically limited.

Near shoring as a low cost alternative to domestic sourcing will assume greater importance for processes requiring the same time zone presence. Latin America with superior cost dynamics will emerge as a near time zone alternative to Europe / US business adding Spanish language capability. In the near-term, the top Indian firms are predicted to expand global footprints and open delivery centers in China, Latin America, Eastern Europe and North America.

6) Pricing pressures will result in reduced rates and new measures to achieve cost savings and higher productivity.

Pricing pressures will kick in as suppliers scramble to meet their quarterly targets through the year. We will see clients negotiating hard with suppliers to reduce costs, while suppliers will try to protect rates but offer more value-added services. *Vinu Kartha, Partner at Tholons says, “The weight of pricing in the contracting process will go up substantially and long-term contracts may also come back to the negotiation table. The net result in our opinion will be a reduction in rates.”*

Large India-based providers are expected to see EBITDA margins plunge below 20% over the

next three years, as they move more IT projects offshore (mostly to India), and struggle to balance operations with rising wages. The situation could aggravate if the Rupee continues to appreciate during this period.

On the delivery front, supplier movement from high onsite to low onsite deployment will be visible and new tactical measures for cost savings and higher productivity towards clients and internal operations will mark new industry standards.



7) Consolidation imminent for small players - focus away from large deals.

On the M&A front, large deals will slow due to a more tepid market. Challenges related to integration and maintaining liquidity (as opposed to acquisition), will also be primary concerns for 2009. *“The average deal size has almost halved in 2008 compared to 2007 numbers, and we anticipate the deal sizes to be depressed due to lack of fresh capital coming from the PE route. However, firms will continue to look for small tuck-in acquisitions to plug gaps in their portfolios and gain client proximity,”* **says Nishant Verma, Vice-President at Tholons Capital.**

Cross-border, inorganic investments are expected to increase in Japan and China with

increased market consolidation seeing small to medium players being likely targets. We also see difficult times for small, non-differentiated players over the next 12 months. As clients look to reduce spends and rationalize costs, new business generation will be very difficult. Also, some of the existing engagements may come up for re-negotiation as clients look to vendor consolidation for better pricing and reduced program management costs. With Tier One firms witnessing flat to negative QoQ revenue numbers, smaller players will find the going tougher, and will be more open to mergers or takeovers to survive. We believe a large proportion of sub -1,000 (employee) companies will either close shop or be acquired.

8) Outsourcing revival by 2009 end - driven by small to mid sized (SME) clients.

The fundamental motivation for offshoring has not diminished – in fact it has actually become stronger. We expect to see a revival in outsourcing, and we are already seeing an uptick in outsourcing related activity for engagements that will come to fruition in 9-12 months. **According to David Hoare, Partner at Tholons Europe:** *“Mid-market customers are expected to expedite outsourcing decisions which have been lying on the backburner. This will be driven by cost pressures and is a step in the battle for survival across the segment. This client sector will prefer being serviced by SME service providers.”*

The mid-market swing will also be aided by providers developing market-specific, full service solutions catering to this space. SME clients have historically found it difficult to tap the benefits of global outsourcing. **Ankur Pawa, Consultant at Tholons, who heads the private equity portfolio firm sourcing says,** *“We see significant interest by private equity firms to look at their portfolio companies and develop strategies to either implement a shared services solution or take a consortium approach to access the global outsourcing suppliers.”*



9) Strong focus on innovation, R&D and technology adoption will be key differentiators for providers.

We expect increased pressure to differentiate one's service offerings. Companies that focus on solution-based selling will weather the storm. Companies that do not innovate will lose market share. **Anand Lavi, Executive Director at Tholons Capital emphasizes,** *"Low cost and differentiation will be the key to sustainability. We have observed that the top India-based vendors have done little to differentiate*

themselves from each other, and offer similar services, pricing, and delivery mechanisms. These firms will need to invest in R&D, offer end-to-end outsourcing and domain consulting services to breakout from the pack." Otherwise, they run the risk of being an also ran compared to larger, feature-rich Multi-National Company (MNC) vendors.

10) Sourcing deal sizes will increase for large clients.

Large clients will move towards single vendor sourcing to get volume based price discounts, as opposed to the best of breed solutions for specific sourcing requirements, which tend to cost more, and carry a higher program management overhead. They will also look for

opportunities to group an asset sale with a sourcing contract, as vendors show readiness to use their balance sheet strength for top line gains. As a result, we anticipate the average deal sizes to go up, even as the overall deal volumes remain depressed.

A copy of this report is available at http://www.tholons.com/Trends_2009.pdf



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About Tholons

Tholons is a Services Globalization and Investment Advisory firm that combines "Best of Breed" consulting experience with deep execution expertise and investment insights to deliver truly effective services to its clients. Tholons offers a detailed understanding of business processes and combines it with practical hands-on expertise in executing the strategy. Tholons draws upon the considerable experience of a hand-picked team, which has successfully formulated and executed globalization strategies to unlock value for Global Fortune 1000 companies. Service providers leverage Tholons expertise to optimize their global delivery model. Tholons advisors engage with government bodies to build compelling strategies for making countries attractive destination for outsourcing.

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