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**Tholons’
Top Ten Trends in
Services Globalization
2008**

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Globalization has taken a strong turn in the past few years. Countries which had earlier encountered roadblocks to globalize have realized the need to source globally for multiple reasons. Drivers have shifted from mere cost arbitrage to more strategic fulfillments such as organic business growth across geographies and reduction in time to market. Worldwide shortage of relevant skills and talent has increased pressure across firms to acquire talent globally. Offshore markets are also tending to move towards being mature global markets for large scale business developments. Together, client markets are expanding to go beyond the USA.

According to Avinash Vashistha, Chairman & CEO Tholons,

“As the IT and BPO industry matures, we see industry consolidation in 2008 among the mid-tier service firms with large service firms leveraging M&A as key element of their growth strategy. Third wave of Globalization will be driven by Infrastructure Managed Services (IMS), Healthcare and Engineering Services.”

Increasing pressures such as the economic downturn in the US and the rupee appreciation has resulted in multiple repercussions including expansion and focus on other client markets. USA still remains the single largest market and will see significant competition from Europe. Maturity in the offshore markets has given confidence to the European firms to further globalize work. Newer business models are emerging in the sell side to beat competitive market pressures eg. “outcome-based” pricing, SaaS and global footprint. The buyer market is increasingly becoming more educated with globalization resulting in informed decision making.

Dr. Pradeep K Mukherji, President – Consulting at Tholons emphasizes:

“2008 will be a year for both challenges and opportunities in outsourcing. While the US elections, weakening of the dollar and sub-prime issues will pose challenges; opportunities will present themselves by way of greater acceptance of outsourcing by Small & Medium Business and constant search for

limited availability of qualified talent. Overall the velocity of outsourcing is likely to be contained”

Clients are now experienced and informed in formulation and execution of their Globalization plans and search for qualified talent will drive client’s selection of geographies.

“We see clients focusing on cities rather than just countries in their search for qualified pool. Cities in Philippines, Russia and Eastern Europe will emerge as preferred destinations for customer service, product engineering and multilingual processes respectively”, says Paul B. Santos, President – Investments at Tholons.

Healthcare industry in US alone is over \$4 Trillion and we see it as a significant contributor to the third wave of outsourcing.

Dr. Garima Vashistha, President – Healthcare at Tholons says, “Healthcare tourism, Pharmaceutical research including Clinical trials, Revenue Cycle Management and Analytics will lead the globalization of healthcare processes. Adoption of Services Globalization in the ultra conservative Pharmaceutical industry will continue to be slow in 2008 but will be on a steep curve as we look towards 2015.”

Many of our predications for 2007 are now established business trends. The emerging trends that we see taking shape in the services globalization space is expected to have a strong impact in shaping the future of global outsourcing.



Tholons' Top Ten Trends in Services Globalization - 2008 will have a significant impact to services globalization for investors, buyers, providers and to emerging centers of excellence:

A. M&A and Private Equity - Growth Strategy through Investments and Acquisitions

1. Going global with private equity participation.
2. Consolidation in the small to medium sized IT/BPO/KPO firms in India.
3. European firms will be both aggressive in building offshore capabilities and will also be key targets for acquisitions.

B. Buy Side

4. Buyer's confidence on Globalization of Services which Impact top line is expected to grow (marketing, engineering design, R&D, etc.).
5. Small and Medium Size enterprises and new geographies like Europe will become more aggressive adopters of global outsourcing to remain competitive.

C. Sell Side

6. Service providers will aggressively pursue competitive strategies which will enable them to establish positions of dominance in their chosen segments.
7. SaaS and "outcome-based" pricing to be in top gear to combat competitive pressures.
8. Sustenance of the Offshore Advantage.

D. Centers of Excellence

9. Buyers will influence emergence of Centers of Excellence – Focus will be Cities not just Countries.
10. Providing quality client services rather than mere low cost solutions will be the main driver.



With the current US\$1.2 trillion spend in outsourcing, only 6%, amounting to US\$77 billion, is being offshored and executed from global low cost geographies. The significant impact that globalization has on financial bottom lines has been well understood by business leaders who are now ready to leverage global outsourcing model further to add value to their business top line. Worldwide shortage of relevant skills and talent has increased pressure across firms to acquire talent globally. This has encouraged organizations to adopt large scale expansion into various global markets and geographies to tap available and untapped resources. However, the gap between the potential and the actual benefits of global offshore outsourcing is based on a myriad of complex factors such as: economic and social dynamics in mature outsourcing geographies like India and China and the lack of awareness of opportunities presented by evolving global offshore destinations like Eastern Europe, South America, Ghana etc.

A. M&A and Private Equity - Growth Strategies through Investments and Acquisitions

1. Going global with private equity participation

This year will see the emergence of a new trend – India based services firms looking at large acquisitions overseas using financing from private equity firms – effectively shedding its traditionally conservative image. Last year (CY 2007) saw some serious outbound acquisitions from India – of the 47 cross border acquisitions involving Indian firms, in 34 instances an Indian firm acquired an overseas firm, while on 13 occasions, an Indian firm was acquired. In value terms however, the total outbound deals from India summed up to a little under US\$1 Billion, while the inbound activity exceeded US\$2 Billion. The year 2008 will see larger outbound deals, and we expect the balance to tilt the other way with total deal value to cross \$5 Billion in Services Globalization. With scale, size and global foot-print becoming the drivers to win large multi-million dollar contracts, the go global strategy is fast becoming a business imperative and this will involve acquisition of large overseas firms with significant financing from private equity firms. Private equity players will bring in professional management to help Indian businesses manage and grow their firms globally. This will lead to the emergence of

true India headquartered MNCs similar to IBM Global Services, Accenture, EDS, etc. This will also lead to India based firms winning part of large, multi-year, end-to-end contracts which normally figure in the billions of US dollars.

2. Consolidation in the small to medium sized IT/BPO firms in global locations like India, China and Philippines

Large PE investors have been overwhelming successful investing in the emerging economies like India and China. The Warburg Pincus investment of an estimated US\$300 million in Bharti TeleVentures and consequent earnings of well over a billion US dollars from the sale of stakes - has motivated private equity firms like General Atlantic, Carlyle and Blackstone to make a beeline to India with significant investments in the IT / BPO services sector. Small and mid-sized players constitute 90% of the firms in the third-party BPO space and the pace of consolidation within this segment will accelerate over the next 12-18 months as private equity and venture capital investors, who are the primary stakeholders in these firms, continue to look at profitable exits. Size matters in the services business and this



year will see significant consolidation in the small to medium sized space to counter decreasing margins and increasing market competition. Chinese service providers, who are primarily small and medium in size at present, will be seen to be aggressively entering the US market to consolidate their presence in the geography, through acquisitions funded by PE or IPO.

3. European firms will be both aggressive in building offshore capabilities and will be key targets for acquisitions

Europe is likely to experience an increased level of consolidation, as European based service providers look to compete with other global services firms. Last year saw 25 deals within Europe, exceeding US\$7.5 Billion in deal value. We expect the pace of consolidation to increase, as European players acquire to gain critical mass. European service providers have the advantage of proximity and cultural affinity in their respective geographies. Consequently, traditional offshore service providers have found it difficult to penetrate the continental European market. Cultural integration with

the offshore (India being the predominant geography), has proved to be a bigger stumbling block for the European players' offshore strategy. The need to leverage offshore expertise and presence has become critical in gaining sustainable mass and staying competitive on a global scale. European firms have also realized that having a presence in the US markets is necessary for them to attain critical mass and keep pace with the emerging best practices. We expect European firms to invest considerably in creating their US presence. Last year saw 12 deals worth about US\$5 billion involving Europe firms acquiring services firms in the US. We expect a 40% growth in Europe / US cross border deals in 2008.

Furthermore, large to mid sized offshore companies, looking to diversify their client base beyond US will also continue to seek smaller European firms to serve as front ends. Eastern European firms will be acquisition targets for US and global offshore firms, looking to set up bases and increase footprints in the European market.



B. Buy Side

4. Buyer's Confidence on Services Globalization which Impact top line is expected to grow (marketing, engineering design, R&D, etc.)

Buyer confidence in globalization continues to increase over the years. With buyers having realized the benefits of offshoring in their back office functions such as IT, BPO – they will increasingly look for globalization opportunities in some of their core areas – such as marketing, design, engineering, etc. – or other operational processes which directly impact their top line. Lenovo has already created a hub in Bangalore to handle its worldwide marketing services including creative development while many other manufacturing companies have started using India and China to help them design and develop new products. GE, Boeing, Airbus, Renault-Nissan are few of the firms who have been early adopters of this trend. We expect significant work in this area to be offshored by clients in coming year with several engagements in marketing and design to be handled by third party suppliers.

As firms have learned from their initial experiences in offshoring, their motivations also have evolved and focus will steadily move from offshoring activities that drive bottom-line optimization to activities that help them grow top-line.

5. Small and Medium Size enterprises and new geographies like Europe will become more aggressive adopters of global outsourcing to remain competitive

Buyer confidence in globalization is now not restricted to the Fortune 2000 companies. It has taken roots in a completely new set of buyers comprising of Small & Medium Enterprises. With risk of offshoring now better understood along with increased knowledge and efficacy of effective mitigation strategies, SME buyers who were far reticent have started taking the plunge. Since, the work portfolio of these companies may not be large enough for established Tier-1 &2 service providers; it throws up a large opportunity for SME service providers, who were otherwise getting marginalized in the market. Aggressive service providers will be looking to price their solutions based on more variable inputs (for example, by transaction volumes) and by “gain-sharing,” as compared to earlier FTE based pricing, to address this opportunity. Also PE investment in the SME sector will drive this growth further.

In addition, new markets such as Europe and domestic markets in large service provider geographies like India and China will become more active in adopting outsourcing, providing additional opportunities and new challenges for service providers.



C. Sell Side

6. Service providers will aggressively pursue competitive strategies which will allow them to establish positions of dominance in their chosen segments

Large service providers have realized that they need to have a dominant position in the markets they serve to win long-term and large value contracts. Pure play offshore providers have had limited success till now in large deals. A competitive strategy to achieve dominance will enable suppliers to offer a complete bouquet of services to their clients and enjoy a better positioning in client markets.

Battle for dominance would be intense with suppliers competing with each other to achieve supremacy in their respective fields in 2008. Suppliers will realize this by building scale both through a mix of large ticket acquisitions as well as small functional acquisitions. 2007 has already seen some of the suppliers take up initial steps through inorganic growth – case in point are some of the large ticket merger & acquisition in recent past like Accenture, IBM – multiple, Wipro – Infocrossing, Infosys – Philips BPO, CSC – FCG & Covansys, Capgemini – Kanbay, Cognizant – MarketRx. We expect increased activity by suppliers in 2008 to expand their global footprint – both in terms of offerings and presence. Firms from all major offshore destinations would step-up their expansion plans as well as look for acquisitions which would give them synergies in respective client markets. Deep and scalable functional expertise will also allow suppliers to deliver significant higher business value to its customers.

7. SaaS and “outcome-based” pricing to be in top gear to fight competitive pressures

The competitive business scenario and lowering of margins due to cost pressures will be drawing service providers towards client-ready business innovation in areas of service delivery, client relationship and pricing. Newer delivery platforms like Software as a Service (SaaS) will be increasingly adopted and experimented with by service providers in their quest to differentiate offering and create a value-based outsourcing proposition. Global SaaS market size has crossed US\$ 5 Billion in 2007 and is expected to grow at over 20% CAGR for next few years. Global IT services majors like Accenture, IBM and CSC are already positioning themselves as enablers by developing SaaS partnership ecosystems and are driving innovation in the SaaS space. Pure play offshore providers are starting to combine IT and BPO offering with SaaS components on a bigger scale which will eventually restructure their service portfolio to include more SaaS-ified offerings. This year will see large offshore service providers redrawing their business models to offer SaaS solutions which may help them break the strong revenue-people linearity chain.

The contours of outsourcing contracts are also steadily shifting towards outcome based pricing from traditional effort based pricing models. As more large deals are stuck, the inherent revenue risk of such outsourcing contracts will act as a catalyst for using more outcome or result based pricing. The revenue contribution of outcome based pricing contracts for large offshore vendors will increase from 8% in 2007 to 14% in 2008. Overtime the ability of service providers to offer new success-fee



based pricing will become a major source of differentiation in the market. This pricing model will result in higher revenue realization for well executed contracts and will help combat margin pressures.

8. Sustenance of the Offshore Advantage

Wage inflation and the marked appreciation of the Indian Rupee and Philippine Peso against the US dollar are believed to have had a direct impact on the savings normally produced by the offshore model. A closer look shows that by using operational and financial levers - this negative impact can be offset to an extent. Service providers will implement innovative approaches to maintain the attractiveness of the cost savings proposition from offshoring for US & European service buyers.

The Indian Rupee has appreciated by almost 13% over the last year and the salaries have gone up by almost 8-12% for people in the industry. Moreover, Philippine continues to hold steady at a 7-year high against the US dollar. In response, service providers have effectively combated this challenge by pulling various levers:

- HR Levers: Flattening the experience pyramid of employees – this has helped as the salaries at entry level have seen a marginal increase and since 0-1 years experience varies between 50-70% of the total work force for companies; the net impact of salary inflation can be

effectively attenuated. Infosys, TCS and Cognizant have made the largest number of job offers (as high as 18,000) to new graduates in the first two quarters of 2007. Companies have also started hiring “non-engineering” graduates to keep cost under control and increase the supply of talent pool.

- Operational Levers: Improved productivity and utilization where a significant amount of flexibility still exists.
- Financial Levers: Increase the Foreign exchange hedge.
- Geographical Diversification: Focus on Europe providing a natural currency hedge. Cognizant’s revenues from Europe for example grew by 92% y-o-y in the third quarter of 2007.

Levers such as these have offset the downward pressure on the savings equations to a considerable extent. However, to further sustain margins - companies have also turned to increasing their billing rates by an average of 3-5%. Moreover, salary inflation is expected to remain under control as the new entrants settle in and the industry continues to hire fresh graduates in larger numbers. Further, as the Rupee and Peso are not expected to appreciate significantly against the US dollar in the long term, the effective use of the offset levers as discussed above – will enable the offshore advantage to sustain its cost advantage in the long-term.



D. Centers of Excellence

9. Buyers will influence emergence of Centers of Excellence – Focus will be Cities not just Countries

Clients to drive the location of service delivery - with increased intelligence and maturity of individual locations to deliver specific capabilities, buyers of services are influencing the decision of service providers with respect to choice of optimal delivery centers. This is also coupled with the fact that for service providers sustaining quality of deliverables and customer retention have increasingly become top priorities. Suppliers today will need to sell a truly global service delivery model versus the conventional one location Niche processes will be performed from multiple delivery centers, thereby increasing process efficiency. There is expected also to be an emergence of "Multi-Shoring" where, different sub-processes will be performed from multiple locations and as part of a re-engineered globalized network of delivery. (e.g. Software development in Shanghai, China with testing performed in Ho Chi Minh City, Vietnam).

10. Providing quality client service rather than mere low cost solutions will be the main driver

Centers of excellence create a niche market for services, thereby moving away from the concept of 'low cost solutions.' Service providers are forgoing a percentage of savings that could have been achieved from pure offshore delivery in order to service their clients better. Global offshore outsourcing suppliers are going nearshore to rapidly establish these centers of excellence which also helps them in accessing and attracting talent in the selected centers. Mature offshore vendors, mostly from India, will be seen aggressively expanding in Europe to set up nearshore centers and also penetrate the mature European market – which by all indication appears ready to globalize. Europe is also expected to emerge as a key market for global service providers.

A copy of this report is available at: http://www.tholons.com/pages/trends_services_globalization_08.asp



About Tholons

Tholons is an **Investment, Advisory and Research firm for IT, Business and Knowledge Services Globalization** who partners with companies to maximize their returns from globalization of both information technology and business processes. Focused on a risk-reward model, the firm leads clients to develop a strategy and fund their business using investments.

Tholons has made significant contribution to leading Global 2000 firms in financial services, healthcare, retail, technology, telecommunications, utilities, oil and gas, consumer goods, logistics, retail, entertainment, manufacturing and other industry sectors. The professionals at Tholons have impacted deals totaling more than \$5 Billion dollars over the last decade. The company is headquartered in Washington, D.C. with offices in the UK, Manila, Bangalore and Shanghai.

Tholons has recently been recognized as the Top Outsourcing / Investment Advisory firm by Black Book of Outsourcing.

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