Cost, Caution and Consolidation Unsettle the Outsourcing Market (Executive Summary)
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The General Sentiment: Unsettled and Uncertain

Since the late 1980s, when IT outsourcing first captured market attention as an alternative to internally owned, operated and managed IT departments, the outsourcing opportunity and value proposition has lived up to the adage "good in good times, good in bad times." Today, however, a hyper-competitive outsourcing marketplace has replaced the previous times of "more business than we can handle." Is it the broader economic and political concerns, the severe downturn in capital markets, or a delayed technology sector rebound that has taken the biggest toll on outsourcing? Or is it the convergence of all these forces that have unsettled the outsourcing market and outsourcers?

Although outsourcers remain optimistic over the long term, outsourcers are virtually unanimous in expecting healthy revenue growth in the future, according to recent Gartner Dataquest surveys. The majority of outsourcers directly feel increased pressure from external market forces and internal business demands. Events have shown that outsourcers are not impervious to economic and business situations of their clients/prospects or industry sectors in which they compete; in fact, their success is directly correlated to the success of their clients. As they seek revenue growth and profitability from a more demanding and equally wary client base, outsourcers face unprecedented pressure from clients and, increasingly, their third-party advisors to deliver reduced costs of operations through outsourcing.

Evidence: Cost, Caution and Consolidation Dominate

Gartner Dataquest identifies the following as three dominant forces shaping the outsourcing opportunity and competitive landscape in the near future:

- **Cost** — Users of outsourcing have one common characteristic — they will be looking to outsource their IT or business processes as a means to reduce costs, either through enhanced operational efficiencies or process improvement. And through improved management tools, internal IS will become more competitive with the outsourcing providers, placing further pressure on deal prices.

- **Caution** — Despite users' undeniable endorsement of outsourcing as a business strategy, uncertainty in business performance will create a new dynamic in the negotiation process that results in protracted decision making and contract signings. Outsourcers must be prepared to stay the course and avoid costly concessions that jeopardize reasonable profits. Outsourcers must also strategize for a shift from labor-based/one-to-one operations services delivery to asset-based/one-to-many operations services delivery.

- **Consolidation** — Consolidation will take many forms that affect both clients and outsourcers that prune their organizations for agility and efficiency, and pursue heightened activity to divest, merge or acquire for competitive advantage. Consolidation brings with it the promise of longer-term opportunity; but invariably there is disruption, short-term angst and confusion commensurate to the magnitude of the change that dramatically heightens the pressure of the present situation.
Key Findings

Key findings and trends for the outsourcing market are as follows.

"Megadeal" Signings Are Still Strong in 2002

Despite concerns that megadeals in outsourcing were drying up, an above-average number of contracts worth $1 billion or more occurred in 2002. As of year end 2002, there were at least 14 megadeals worth a total of $28.4 billion, compared with nine such deals in 2001 worth a total of $15.1 billion. The average annual number of megadeals since 1991 is 7.4. Pipelines are still strong with more than $15 billion in megadeals still pending final negotiations as of year end 2002.

IBM Leads in 2002 Megadeal Wins

A review of the past 12 years of megadeals shows that EDS and CSC were clear early leaders in this field, but IBM quickly surpassed them and now has a total of at least 32, nearly the same as EDS (21) and CSC (15) combined. As of year end 2002, IBM had won seven of the 14 megadeals awarded in 2002, and shared an eighth deal with Keane. CSC has won one and EDS won two deals, but both were in final discussions for several, separate megadeals. HP and Fujitsu landed their first megadeals, and CGI its third.

More Shifts in Competitive Landscape Result From Acquisition, Rebranding and Bankruptcy

During the past three years, more than 57 outsourcers have been acquired. Familiar names such as Comdisco, Compaq Computer, debis Systemhaus, Exodus, Entex, Inacom, Policy Management Systems, PwC Consulting, Sabre and Wang are no longer part of the competitive landscape. More than 17 other companies have changed their names to rebrand themselves and establish new identities in the marketplace, such as Andersen Consulting to Accenture and Deloitte Consulting soon to be Braxton. Finally, at least 13 outsourcers have left the services business, such as storage services companies turning their focus to software only, or have dissolved through bankruptcy, such as Comdisco, FutureLink, marchFIRST and Pandesic.

Delays in Outsourcing Contract Signings Lengthen Because of Buyer Caution

Outsourcers report that clients need less education about outsourcing, shortening the first half of the sales cycle and reducing its cost. But, at the same time, clients are taking six to 18 months longer after the down selection to sign contracts. The second half of the sales cycle is more expensive because once an outsourcer has been chosen as the finalist, high-level teams are put together to see the process through the signing and into operation.

Delayed contract signings mean the outsourcers have to maintain that team at their own expense for a longer period of time. Protracted contract negotiations also incur additional costs (time and legal expenses) that the vendor must absorb. Coupled with a focus on reducing costs, outsourcers must monitor closely the cost of sales as a factor in margin performance. For 70 percent of the outsourcers surveyed for this report, the average cost of sales as a percentage of revenue is 10 percent.
Demand for Offshore Services Accelerates as a Means to Ensure Low-Cost Services

Cost reduction initiatives in enterprises are increasing, causing enterprises to offshore service delivery for everything from applications support and maintenance to remote operations monitoring and management, help desks, and call centers. Outsourcers are responding with expansion of their offshore resources either through investments in new facilities or through partnering.

IT Budget Constraints Influence Opportunity — Good and Bad

Discretionary IT projects have been trimmed from IT budgets, but so have staff and funds for hiring. Outsourcers are finding their resources in demand to fill staffing and skills needs for ongoing operations, server consolidation and deployment.

Selective Outsourcing Revenue Dominates, but Full Service Outsourcing Revenue Is Rising

Selective outsourcing provides the majority of revenue for most outsourcers, but survey respondents expect full-service outsourcing (defined in the survey as "comprehensive infrastructure management services, annuity relationships") to increase during the next two years as a percentage of all revenue.

Applications Services Become Hottest Growth Areas in IT Outsourcing

Growth expectations are greatest among outsourcers for offshore applications services, followed by near shore and application management in general. At the bottom of the expectations chart is designing and building data centers, with storage services only slightly better.

Walk-Away and Win Rates Increase in 2002

Although the walk-away rate (contracts not pursued) has increased 3 percent during the past two years, the win rate has increased dramatically during the same time period by more than 9 percent. The findings reflect a greater seriousness of intent among enterprises that are exploring the outsourcing option as well as a greater selectivity among outsourcers anxious to avoid unprofitable or risky engagements.

Third-Party Advisors Increasingly Involved

Another possible factor in the seriousness of intent to outsource and the selectivity of outsourcers is the increasing presence of third-party advisors. Outsourcers acknowledge that third-party advisors can "level the playing field" in terms of expertise brought to bear on both sides of the bargaining table. However, outsourcers believe the role of third-party advisors is focused too heavily on pricing and is not balanced with a view toward business value and cost. Two years ago, only 14 percent of the respondents found third-party advisors involved in more than 40 percent of the contract negotiations. Today, nearly twice as many outsourcers (26 percent) are seeing third-party advisors in more than 40 percent of their negotiations.
Client Focus Tops Outsourcers' Key Initiatives and Growth Strategies

Formalizing client satisfaction monitoring tools topped the list of key initiatives for outsourcers that rated the verticalization of outsourcing offerings, the transformation of client business strategy and making benchmarking a standard component of contracts their other top initiatives. Expansion of business with established clients and broadening the client base were overwhelmingly the top growth strategies among outsourcers, with BPO a distant third.

Gartner Dataquest Perspective

The outsourcing market is more unsettled and uncertain this year than in the past, yet it offers great opportunity over the long term. For current players, and those considering entering the market, the bar for success has been raised. The largest global outsourcers experiencing significant change, visible failure or depressed market capitalization may suffer considerably during the coming year. The door may open for midtier or niche/focused outsourcers, which, because of their size, are less burdened by demanding growth targets and overhead, and potentially offer the following compelling value proposition to clients:

- Higher levels of client relationship focus
- Technical expertise at a more competitive and cost-effective price
- Flexibility and focus
- "Premium" support with less burdensome administrative procedures

The Key to Success: Rethink Strategy, Focus Resources and Pursue Only Profitable Outsourcing Business

The survival of many outsourcers is contingent on their ability to address the forces of cost, caution and consolidation with new business strategies during the coming two-year period before the market recovers. Market leaders in outsourcing will use 2003 and 2004 as a time to declare their dominant outsourcing approach either as a full-service outsourcing provider (IT or BPO) or a niche outsourcing provider. Outsourcers that waver will be candidates for takeover because consolidation is inevitable when the economy rebounds.

Furthermore, outsourcers must prepare for another year of cost-focused deals and delays in the outsourcing decision-making process caused by buyer uncertainty; slowed economic recovery, lackluster business performance and emerging options for the delivery of IT services underlie this buyer behavior. Second-tier or niche outsourcers with efficient operations and customer focus may have a window of opportunity to attract new enterprise clients that opt for a smaller/niche player to ensure stable project teams and more personalized customer support.

Recommendations to Outsourcers

- Avoid overreacting to today’s unsettled conditions; maintain a long-term view of business requirements while putting out any immediate fires, and sort out one-time events from systemic issues.
- Resist the temptation to grow top-line revenue at any cost; rigor in outsourcing opportunity analysis will be more important than ever to ensure profitable revenue growth.
Map out corporate strategy for the next five years with regard to competitive positioning and opportunities in offshore services, IT utility services and BPO.

Evolve alternative contracting methods for key clients that include performance-based clauses as a means to ensure close alignment of goals and outcome. These alternative contracting methods will be required in the future on a broad basis with clients as IT infrastructure service are commoditized and the value of the contract is delivered through business transformation and optimization services.

Closely monitor successes in contract win rates and continuously revise the presales contract review process to evaluate key determinants for bid/no bid situations.

Ensure a well-balanced portfolio of contracts, ongoing examination of contract performance and new attention to risk management and contract provisions for default to avert costly failures.

Declare a clear market focus and value proposition that must include proof of cost savings for utility relationships or added revenue or business value for enhancement or transformation relationships.

Prepare new business models and accounting practices to address the challenges of IT utility service delivery and heightened concerns over corporate financial management issues.

For the full report, see the Gartner Dataquest Market Trends, "Cost, Caution and Consolidation Unsettle the Outsourcing Market" (ITOU-WW-MT-0106).