IBM Accelerates Its Focus on Application Outsourcing

IBM Global Services formed its Applications Management Services line of business in July 2001 to harness its application capabilities and take advantage of the growing momentum among enterprises to outsource applications.

Most competitors and enterprise clients know that IBM Global Service's (IGS's) outsourcing strength and core competencies are its IT infrastructure services for data centers, desktops and networks. However, they shouldn't overlook IGS's accelerated attention to its Applications Management Services (AMS) line of business as a key element to expand and grow IBM's outsourcing business.

Gartner research reveals that, through 2008, growth for application management services will be 11.6 percent, exceeding application development and deployment, which will grow at 4.3 percent and 4.6 percent, respectively.

Converging Forces Lead to the Launch of IBM's AMS Unit

Two years ago, Doug Elix, worldwide leader of IGS, and his senior executive team identified its wealth of resources in application services and the groundswell in enterprise clients' attention to optimizing their portfolio of business applications. Furthermore, IBM was aware that, in its strategic outsourcing relationships, it must capitalize on its infrastructure, application, systems integration and business process skills in a more synergistic offering of services. In particular, IBM faced a new competitive threat of external service providers (ESPs) aggressively pursuing outsourcing, leading with business solutions, applications expertise and consulting skills — not infrastructure service support.

Of IBM's 30,000 AMS personnel, approximately 83 percent (or 25,000) focused on client-facing activities for delivering services. The remaining 17 percent (or 5,000) supported internal applications for IBM operations. Although IBM had vast application skills and resources, these skills were not being optimized:

- IBM lacked a dedicated application service business with management focus.
- IBM's application tools and methodologies were inconsistently deployed.
- IBM was pursuing application outsourcing opportunities on a deal-by-deal basis — an opportunistic vs. strategic approach.
• IBM's sales/account management growth strategies did not encompass an application service focus.

• The collective market share being captured by Indian offshore ESPs among U.S. customers (estimated at more than $6 billion in 2001) was primarily at the expense of the largest U.S. ESPs, such as IBM and EDS.

Other key market forces were also converging on the application space, making it attractive for outsourcers to move into application outsourcing:

• Commoditization — Commoditization had occurred in infrastructure services, but it was less prevalent in application services, given the close connection of business applications to business impact/outcome. The prospect of more-favorable margins in application outsourcing was promising to vendors.

• Cost focus — Enterprises were now placing increased focus on their application portfolios and how to tap into vendors' expertise, infrastructure and processes to effect needed cost controls. Furthermore, emerging offshore service companies offered compelling application cost savings.

**Synergy of Application Outsourcing With IBM's Growth Strategy**

IGS pinpointed application outsourcing as the nexus between its rigorous and evolving IT outsourcing business growth targets and its intent to strengthen its business consulting-led client relationships. Through the launch of AMS in July 2001, IBM set itself on a path to build its brand in terms of application outsourcing — an area where it had been only marginally committed and moderately successful.

Five years ago, IGS relied on an extensive network of subcontractors to deliver its offshore service model. Being global and operating in many countries, IBM had significant capital investments and employees in foreign locations. Many of the application service resources were used to support internal IBM application development/management projects. The intense focus since the launch of AMS has been to make a "paradigm shift" in those foreign locations to transition the employee base to client-facing delivery resources capable of delivering application services to U.S. clients from offshore locations. This is a difficult transition and a "work in progress" for IBM.

**AMS Service Offerings**

IBM's AMS service offerings span the life cycle for application support:

• Application maintenance and management services for legacy and e-business applications

• Packaged application implementation and outsourcing — design, deployment and the ongoing management of enterprise resource planning packages

• Application hosting

IBM also has plans for new application service offerings that focus on portfolio management and legacy transformation.

**AMS Delivery Infrastructure**

AMS offers service delivery on-site through local resources, off-site via AMS regional centers, "nearshore" (in a country geographically close to the client's site) and offshore. The AMS centers reside in 30 countries (for example, Canada, Mexico, India, China, Australia, Belarus and Russia). AMS reports
that it has approximately 8,000 offshore professionals (this number excludes resources in Canada and Australia):

- Approximately 90 percent are direct IBM employees, and the rest are resources obtained from subcontractors and partners.

- Approximately one-third (or 2,600) serve internal IBM system/application requirements, and 5,400 are a combination of IBM employees, subcontractors and IBM business partners supporting clients (for example, the IBM Belarus location consists of several hundred staff who are employees of IBM's business partner).

- IBM's utilization rates of these personnel to deliver offshore-based services to U.S. clients range from 30 percent to 40 percent.

**Standard Methodologies and Processes**

Evolving global consistency in standardized procedures and a standard delivery framework throughout its global infrastructure is a priority for AMS. It employs the Software Engineering Institute's Capability Maturity Model certification standards, but it also adheres to IBM's "Global Services Method," which is the integrating framework for its Business Consulting Services (BCS) unit and infrastructure outsourcing offerings. Theoretically, this ensures consistency and common practices to seamlessly knit together its vast resources in client engagements. There is not enough critical mass of client feedback to determine how well this is working, especially because the acquisition of PricewaterhouseCoopers Consulting resources in the BCS division. One area of focus for IBM research in support of AMS strategies is the creation of a methodology for assisting customers in determining the optimal mix of domestic, nearshore and offshore support of their various application service requirements.

**AMS and "On Demand" Services**

IBM's new on demand initiative is premised on an evolution from e-business application hosting to new delivery methods for real-time application services, including application monitoring, flexibility to map usage to user requirements and on demand pricing, among others.

**A Look to the Future**

It is estimated that AMS represents about 16 percent ($5 billion) of IGS's total revenue of $31 billion and approximately 15 percent of IGS's total 175,000 employees. As IGS clearly acknowledged in launching AMS, the advancement of its application outsourcing business will be critical to strengthen and evolve its broader market share and "mind share" in the IT service market. AMS potentially brings higher revenue growth, the requisite application service competencies to evolve higher-value (higher-margin) client relationships for business impact and transformation, and also supports new constructs for on demand utility-like services.

However, ensuring success with AMS will take considerable management attention and investment. The critical components will be to achieve competitive parity in the global delivery model and build competitive advantage in emerging offerings. IBM was "late to market" in evolving this part of its business in a unified, comprehensive and focused fashioned. As a result, it is in catch-up mode to be of world-class stature. AMS does not operate as a stand-alone profit and loss center within IGS, but rather, it is a shadow profit and loss center to IGS. AMS also houses many of IBM's internal application services. Thus, it will need to ensure that the appropriate performance-based metrics for client-facing activities are in place to ensure focus, growth and agility with regard to market responsiveness.
For example, IGS’s strategy is to first use its internal organization as a test mechanism for new services and delivery strategies, which it did to test its offshore application services in India. Although the concept is good, there are critical competencies that are required for client-facing work vs. internal work. Thus, this will be a continued source of "growing pains." In addition, it took significant time for IGS to appropriately react to the types of pricing structures that were being offered by Indian offshore firms among U.S. customers. It was not until IGS experienced consistent loss of opportunities that it finally shifted its model. In 3Q02, Gartner began to see IGS respond to client requests for proposal with competitive rate structures for programmers offshore. Going forward, Gartner expects to see IBM employ extremely aggressive pricing models in comparison to Indian offshore ESPs.

**Opportunities: What AMS Needs to Do**

Gartner believes that AMS is the promising "sweet spot" for IGS’s future business. AMS holds the promise for upsell opportunities in SO and also as the bridge between SO and BCS. Gartner believes that IBM must prioritize the following key initiatives:

- Continue the ongoing transformation of the offshore workforce to ensure parity with major competitors.
- Develop the processes, delivery procedures and offerings to be globally consistent and leading-edge.
- Capitalize on the advantage of having a truly global portfolio of options beyond just India-centric offerings; this involves developing decision frameworks for country-based application portfolios for business case and risk analysis.
- Perfect its application frameworks and global service delivery methodology and processes to ensure that integration with BCS and SO occurs seamlessly.
- Transition completely from the heritage deal-by-deal approach to application outsourcing to become a perfectly tuned, process-consistent organization.
- Clarify how AMS supports and promotes IBM’s on demand strategy.
- Invest in brand awareness for IBM’s AMS capabilities, both internally (for sales optimization and client-facing systems) and externally.
- Centralize a strategy for application hosting to ensure efficiency, timeliness and the cost-effectiveness of these new offerings across IBM (SO, BCS and e-hosting).
- Expand the IBM research commitment and investment commitment to secure industry "thought leadership" for IBM BCS and also AMS’ applications process expertise (thus addressing the delicate balance of cost savings and business value for enterprise clients).
- Continue to evolve a global delivery model for AMS, relying on organic growth for the near term (while the PricewaterhouseCoopers Consulting acquisition and assimilation is a top priority) and then later consider an acquisition if appropriate.
- Be forward-looking and determine the optimum level of offshore resources based on supply and demand, as well as its own channel balance for delivery services.
- Ensure that AMS capitalizes on IBM’s broader "first mover" advantage in China and translate this into building greater AMS capacity and presence.
Threats and Challenges

AMS’s biggest threat will be the lack of urgency to transform itself. Failure to take the steps mentioned in this research will result in an underoptimized, opportunistic approach to application outsourcing vs. a strategic approach. In addition, AMS’s ability to measure and monitor the “right key performance indicators at the right time” internally is also a lingering question.

Competition is another formidable threat, particularly with the onslaught of new offshore players and the consultants/integrators that are tackling the outsourcing market principally from the applications and business process outsourcing competency areas. AMS will have to compete more aggressively against niche competitors that can offer greater focus and flexibility. Although AMS may use aggressive pricing to compete and build its market share, it must ensure that it delivers profitable revenue growth to the IGS. Many of these competitors will forgo the infrastructure services play as being too capital-intensive (and, alternatively, will form partners in this area). Instead, they will focus their investments on developing their brand value for application expertise, technical/business process excellence, deep industry skills and so forth — precisely where BCS will seek to offer value and where AMS must bolster the larger IBM brand value.

Another potential threat is IBM’s failure to fully recognize that the success of BCS links closely to the success of AMS. The skillsets from AMS will be critical for BCS to succeed in the high-value and business process outsourcing arenas. Failure to seamlessly integrate AMS and BCS will result in inefficient (less-profitable) engagements, duplication of skills or lost opportunity.

**Bottom Line:** Gartner’s overall rating of IBM’s application service offerings is promising, indicating that its offerings demonstrate potential. However, IBM’s Applications Management Service line of business is evolving. AMS clearly has achieved two critical resource-intensive ingredients — considerable head count and a geographically disperse, capital-intensive infrastructure. IBM must parlay these assets into offerings that are leading edge in vision and execution.