STRATEGIC GUIDE

Surprising Trends in IT Outsourcing

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The Cloud Shakes Up the Industry

FROM THE EDITORS OF

CIO

BUSINESS TECHNOLOGY LEADERSHIP

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EDITOR'S NOTE

The Outsourcing Reset

The head-long rush to use programmers in India is ebbing. CIOs are suddenly taking more of a "pick your spots" approach: some outsourced IT work may still be done in Bangalore, but some may be done in Detroit or Cleveland. Why the change of heart?

A recent Forrester report says the movement to domestic outsourcing is accelerating as software becomes a key differentiator for American business. "Clients require agility and also lightning-fast time-to-market," the report says, without communication and time-zone hassles. Plus, in India, "prices are inflating, attrition is increasing, and quality is on the decline." Yes, the U.S. labor costs slightly more, but that can be offset by the productivity gains.

This is just one of the big changes occurring in IT outsourcing. The following report will help you navigate the latest trends in this important market.

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1. CIOs are having second thoughts about offshoring.

No, CIOs who handed off the entirety of IT to a third party haven't brought it all back in-house. Technology leaders racing toward an 80-20 offshore-to-onshore ratio for IT service delivery didn't suddenly decide to invert those figures.

The shift in IT sourcing strategy has been subtler than that, but no less profound: CIOs today are taking a more surgical approach to outsourcing. A bias to send as much development work as possible offshore has been replaced by a predisposition to keep a greater portion of that nearby or in-house. And the once-shrinking category of the IT organization's core competencies has been quietly growing once again.

Take GE, the offshore outsourcing pioneer that began sending work to India more than 15 years ago. A bellwether for IT outsourcing, the $150 billion company once had half of its IT work being done by non-GE employees.

But GM's recent announcement that it will bring most of its IT work back in-house over the next three to five years was certainly a dramatic about-face for the automaker, which was an early adopter of outsourcing and offshoring.

Former GM CIO Ralph Szygenda's "third wave" of outsourcing is being replaced by new CIO Randy Mott's first generation of insourcing, resulting in the $150 billion company's hiring—or rehiring—10,000 technology professionals.

"GM seems to index far to one side or another—first being a major outsourcer to one primary firm, then creating a very public multi-vendor environment with shared responsibilities and risks, and now actively espousing [its] insourcing decisions," says David Rutchik, a partner with outsourcing consultancy Pace Harmon. "These [moves] grab attention but need to be right for the business goals."

"Most other car operations have this capability and it is not surprising that GM would follow this direction," says Peter Bendor-Samuel, CEO of outsourcing consultancy Everest Group. "What is surprising is the [scale at] which they are attempting to do this."

"Many organizations have been beefing up their internal organizations for several years now after outsourcing a good piece of their IT work," says Phil Fersht, founder of outsourcing analyst firm HfS Research. "In many cases, IT departments have moved out too much work that requires closer interaction with the business and an understanding of the organization's institutional processes. Many have had to feel their way in learning what balance of in-house [versus] outsourced works for them."

When Joe Sniado became CTO at Standard & Poor's six years ago, the company was in passionate pursuit of what many CIOs considered the ideal ratio of offshored to onshore IT delivery: 80-20.

And, like most IT groups, they never got there.

2. Smaller Deals

A decade-long decline in the size of IT services contracts continues. While the number of mega-deals and midrange contracts awarded each year has remained fairly stable since 2002, the number of those worth $100 million or less has more than tripled, according to outsourcing consultancy Information Services Group (formerly TPI).

There was solid tactical and strategic reasoning behind the goal. "We needed to do a lot more work to support a business that was globally integrated. We needed to digitize our business," says Sniado, now CIO. "We didn't have sufficient staff in our New York office to get that done, and it would have been too expensive to build it out. That drove us to an offshore model."

But in 2008, S&P adopted new agile development processes to help the business increase speed to market. At first, agile and offshore didn't mix.

That's when they ran into headwinds on the journey to 80-20, says Sniado. "We were finding it hard to work with offshore teams with these new software methods," he says. S&P had to train its offshore outsourcers in its own version of agile development. Any offshore outsourcing veteran knows that to succeed, the customer may have to make an investment in adopting the processes of the vendor, but financing training in the other direction isn't often factored into the equation.

Even then, some of the offshore partners were slow, and that had a ripple effect on the business.

"We had to figure out how to deal with that, because that velocity was tied to how fast we could get new things into the marketplace," Sniado says. "We were frustrated."

Sniado eliminated suppliers that couldn't pick up the pace and required the rest to provide more on-site personnel. "That drove up costs but accelerated development," he says.

"The nature of technology projects is changing; people are doing smaller, more controlled projects with more agile-based methodologies that require that technical practitioners be involved in not just application development and testing, but also the entire process," says Jeff Wissink, partner with business and technology consultancy Navint Partners. "It's just not terribly practical to try to invoke the offshore model with these kinds of more fluid IT-governance structures, nor are the cost savings as tempting or obvious."

Sniado is now pushing providers for more offsite-but-local options, ideally two to three hours outside Manhattan—close enough to reach by train but far enough from corporate headquarters that salaries are 25 percent lower. "We're seeing a real limit on the type of work we can offshore," says Sniado. The 80 percent offshore objective has been discounted to at least 70 percent. For new development, it's closer to half.

"80-20 is an easy thing to measure when you think [that goal] is highly correlated to saving money," Sniado says, "but you can't push mindlessly toward that."

Today, staff costs and overhead can be greater in India than in parts of the United States, when

3. New Pricing Models

With continued pressure on their profit margins, outsourcing providers are considering **more innovative–and often riskier–engagement models**, including joint ventures, business-outcome-based pricing, revenue-sharing arrangements, and dedicated centers of excellence. For analysis of the **pros and cons** of these pricing models, **go online: http://www.cio.com/article/704153/.**

taken as a whole, according to Malcolm Swallow, principal adviser with KPMG. Wage inflation is 10 to 15 percent in India, while many American cities face wage deflation, he says. And given the importance of labor costs in the offshore outsourcing equation, that's a significant change. Recently, the Hackett Group predicted that the number of IT jobs heading offshore will plateau by 2014.

The 80-20 offshore-to-onshore ratio may have served a purpose for a time as a change-management tool, but it's likely outlived its usefulness.

"Years ago, it was all about, 'How do I get that labor arbitrage? What are the roles and where can I source them?'" says Rich Pople, principal in charge of IT transformation consulting at the Hackett Group. "Now they're looking at that in the context of, 'What is the service I'm offering to the business and where is the rightful place to put that?'"

4. The move towards "domestic outsourcing" is accelerating.

After more than a decade of offshoring IT services to countries with lower wages, can CIOs afford to consider sourcing work stateside anymore?

The answer, say outsourcing experts, is increasingly "Yes."

Bob Bayer, IT director at Forest City Enterprises, recently transferred the $1 billion real-estate company's previously outsourced help desk to New York City-based Genesis10, which has IT service centers in Kansas City, Mo.; Cleveland, Ohio; Troy, Mich.; and Atlanta, Ga. When tier-one (or, front-line) support was offshore, "communication was a challenge—both the strong accents and the lack of understanding," Bayer says. "Knowledge transfer was also a challenge. As things changed or we introduced new functionality, it was difficult getting the offshore team up to speed."

Since moving the help desk to the United States, Bayer says, end user satisfaction is up, the outsourced team adapts more quickly to changes, and integration with the in-house tier-two and tier-three support teams is tighter.

According to a recent Forrester Research report, there are a number of factors accelerating the trend toward domestic outsourcing, including the need for business alignment and agility requirements, rising salaries and attrition rates in India, visa issues preventing offshore vendors from providing onsite resources, and the political demonization of offshoring.

In addition, U.S.-based outsourcing staff are rated better in several key capabilities, according to a survey by outsourcing analyst firm HfS Research. Of the 215 enterprise buyers interviewed, 75 percent said domestic IT service providers offered good cultural understanding and communication skills, while 30 percent said Indian vendors did the same. Similarly, 82 percent gave U.S. workers high marks for business understanding and 72 percent were pleased with how they took initiative, while, respectively, 37 and 38 percent of respondents gave the same accolades to India's workers.

In the survey, the enterprise buyers also said they would consider outsourcing IT services domestically if they could save 16 percent compared to doing the work in-house. For India, they required a 22 percent savings.

Companies that factor in the total cost of outsourcing may realize that domestic outsourcing can be less expensive than offshoring, says Stephanie Moore, an analyst with Forrester Research. The domestic delivery model may offer increased productivity, fewer travel costs and less management overhead.

"Ten years on, mature buyers of offshore outsourcing are saying the cost benefits might be outweighed by other values," says Phil Fersht, CEO of HfS Research. "You might have saved 30 percent in costs but lost 30 percent in terms of the ability to understand the business."

That doesn't mean that CIOs are bringing back their all their offshored IT and planting it in the United States. But for new and higher-level IT requirements, outsourcing closer to home may be the better choice.

5. Multi-Sourcing Wranglers

CIOs have largely rejected broad, single-source deals in favor of a **best-of-breed outsourcing model that uses a variety of specialty firms**. But that doesn't mean they've figured out how to manage the multi-sourcing beast.

Some IT organizations are hiring people to bring the necessary management skills in-house. But IT service providers are also setting themselves up as **services integrators that will oversee multiple providers** and manage end-to-end delivery. Time will tell how well this **fox-watching-the-henhouse model** plays out.

6. Outsourcing contracts and negotiations are getting more complex.

Given the maturation of the IT outsourcing market and the introduction of more standardized offerings like cloud computing, you might assume that negotiating IT service deals is getting easier.

Not according to the lawyers hammering out the agreements.

KPMG reports that 41 percent of outsourcing attorneys surveyed for its 2012 Legal Pulse report indicated that complexity in contracting for outsourced services—as evidenced in things like service levels, contract structure, pricing models, use of global sourcing—has actually been increasing. (The survey included outsourcing attorneys at 31 law firms.)

"As buyers gain more experience they continue to push the envelope in terms of scope, complexity of work outsourced, number and diversity of service providers utilized, geographical scope and mix of service delivery models. Complexity comes with the territory," says Stan LePeak, KPMG's director of research for advisory services. "So while the outsourcing market is maturing, it is not necessarily getting simpler, easier, or safer."

Address IT Complexity Upfront

A complex contract, in and of itself, is not a bad thing. It can result in greater benefits for the outsourcing customer or may better address issues of pricing, performance and risk "Problems arise when complexity is not adequately addressed, recognized or accounted for upfront and in the ongoing management of the outsourcing efforts," LePeak says.

The key is to make sure that the level of complexity in the legal documents is commensurate with the nature and goals of the outsourcing arrangement and not just the result of a once-burned buyer or overzealous counsel.

Typically, as services markets mature, best practices in contracting tend to cement themselves in the way of standardized pricing, performance assurance and—particularly—defined terms. However, 27 percent of the attorneys polled reported little or no standardization in defined terms, which LePeak says also points to the fact that while outsourcing is maturing, it's also been expanding into uncharted territory in terms of scope, objectives, and geography.

The survey asked about the most contentious issue in outsourcing negotiations. The most challenging contractual terms to reach agreement on were limitation of liability, indemnities, step-in rights, pre-defined direct damages, and supplier financial risk—all of which involve potential financial exposure to supplier or client. The most challenging commercial terms to come to consensus on were termination fees, termination rights, service levels, transformation and transition fees—all of which involve service provider risk.

Arguments over terms related to transformation rated 17 percent higher than last year as more buyers are attempting to include transformation goals in their outsourcing engagements. "Transformation involves building into the contract terms, conditions, or measures for process transformation or for innovation or other nebulous but value-laden keywords," says LePeak. "The challenge is translating a somewhat conceptual idea like transformation into contracted terms and conditions and factoring in all the events and conditions that could impact transformation being achieved or not."

The toughest negotiators by far continue to be the traditional global outsourcers like IBM, Accenture and HP, according to the attorneys surveyed. Contracting with India-based service providers such Infosys, TCS and Wipro tended to be a less complex, contentious and lengthy process, according to the KPMG Research, while the easiest to deal with were regional or niche suppliers.

"Some of the legacy firms just have more and more aggressive lawyers, and there are also situational variances and exceptions across all classes," says

7. Increased Focus on Security

It's only a matter of time before a major IT service provider suffers a **public security breach**. Outsourcing companies are looking for new and better ways to protect data–their own and their customers'–says Mark Ruckman, an independent outsourcing consultant at Sanda Partners.

In the meantime, **security liability limits** have become one of the most **contentious negotiation issues** between outsourcing customers and vendors today.

LePeak. "But as some respondents noted, legacy firms negotiate harder but remain professional and are less likely to come back later with requested changes and some Indian firms were easier to deal with but would come back later with requested changes or would not negotiate as solid a contract as is possible. So some of it is style and some of it is substance."

And like complexity, a little back and forth during negotiations can actually be a good thing if it leads to a better or more equitable deal. "Were one side to roll over in negotiating, or if contentious points were ignored or not resolved before the deal is signed, it would be worse," LePeak says.

"Ultimately you want the best deal and contract and one that has no holes, meets both sides' needs and reflects the spirit of the effort, and sometime it's harder and more contentious to get to that point," LePeak says. "The key is that when all is said and done both sides are satisfied with the deal, and any contentiousness was not so bad that they can't stand each other and can't possibly work together going forward."

8. Cloud services are shaking up the IT outsourcing industry.

The number of cloud-related contracts signed in the third quarter of this year was up 120 percent over the same period in 2011, according to the quarterly TPI Index produced by of Information Services Group (ISG).

Half of the service providers surveyed by ISG said that a quarter of the engagements in their pipeline included cloud computing services and all of them expected cloud services to grow faster than traditional IT outsourcing particularly in the Americas.

However, Software-as-a-Service (SaaS) and Infrastructure-as-a-Service (IaaS) are taking very different trajectories, says ISG's emerging technology analyst Stanton Jones. "SaaS is more narrow, and we're seeing units outside of central IT lead the drive to evaluate and purchase," Jones says. "IaaS is broader and is IT-led. We do not see as much growth here because IT functions are preferring to play it safe and stick with more modernized and standardized infrastructures."

But software in the cloud could take a bite out of both IT infrastructure and applications outsourcing. "Emerging IaaS providers will not take over a full-scope infrastructure sourcing deal from a traditional IT service provider," says Jones.

"Emerging SaaS providers however can take over an entire functional stack like HR, displacing the incumbent hosting provider and the application development and maintenance provider because the SaaS provider provides the hosting and the application run, and the need to heavily customize goes away in favor of configuration." And traditional vendors that turn their on-premise software into services, too, can displace traditional IT service providers.

Speed Matters

While early SaaS cloud adopters have found that cloud options are not always cheaper, they're drawn by speed of implementation, access to features, and mobile capabilities, says Jones. What's more, they don't have to go to IT to get it done. "They get to drive the bus for the first time," says Jones.

Leading the way is human resources. "A large percentage of our HR outsourcing clients are taking a long look at SaaS," says Jones. Just behind them in cloud contracting activity is IT, most often looking at communication and collaboration tools and cloud-based IT service management, Jones says.

Enterprise-wide adoption of cloud solutions, however, is hit or miss. "Units outside of IT want to move these projects forward, but when they get to the real work of building a business case and negotiations, the projects can bog down because they are focused on features, not the impact to IT, legal, finance and procurement," says Jones.

As for IaaS, some business units are buying into the public cloud on a small, workload basis, but corporate IT still prefers dedicated services — private clouds either hosted themselves or in their provider's data centers. "In our new scope and renegotiation deals, we're working with clients and providers to make sure they have the option to move workloads to the provider's shared IaaS platform in the future, but that percentage is still very slow," says Jones.

Traditional software vendors have a chance to take infrastructure away from traditional service providers for specific application towers. However, they'll only be cannibalizing their own revenue streams."

Traditional Western IT providers are expanding into cloud services, but may have difficulty integrating their acquisitions in this area, says Jones. Indian IT service providers' application transformation work is the perfect "gateway to cloud," Jones says. However, their historical resistance to investing in assets means they will have to rely on partnership if they want to play in the cloud space.

Reporting by Stephanie Overby