



Investments • Advisory • Management



**Trends in
Services Globalization
for 2007**

www.THOLONS.com

1. Small and Medium Enterprises (SME), driven by Private Equity investors, will become significant participants in services globalization.

Traditionally, the SME segment has not been able to match the speed and scale of larger organizations when it comes to exploring newer markets and adoption of services globalization. 2007 will see private equity investors influencing the SMEs to aggressively adopt services globalization. PE investors have started to develop an ecosystem for their portfolio companies to co-source services and set up operations offshore. This ecosystem provides for shared expertise and learning, and provides an ideal platform for services globalization. Technological advancements and lower telecom and bandwidth costs, along with newer sourcing

models have helped the cause of globalization for SMEs.

The influence of private equity has not been limited to the buy side only. The offshore services sector, fuelled by PE investments, will see a new high in 2007. Close to \$5 billion in PE funds are expected to be available to offshore IT and business process outsourcing (BPO) and knowledge process outsourcing (KPO) firms in 2007 to expand their operations. Many PE and buy-out funds have been conducting market reviews and target mapping activities in India and the Philippines for a year now.

2. Firms will adopt the “Cities of Excellence” model, sourcing services from the best location for respective ITO/BPO domains / processes

2007 will see many more countries and cities becoming centers for outsourcing. Cities such as Prague, Halifax, Budapest, Warsaw, Pune, and Bucharest are already centers for outsourcing but they are becoming more expensive and less differentiated. As a result, other cities such as Bratislava, Ho Chi Minh City, Kolkata, Xi’an, Buenos Aires, Krakow, Colombo and Sofia are on their way to becoming centers of outsourcing in 2007.

Organizations will move towards a distributed model for services globalization, looking to source the best possible skills from locations which can best deliver them. Over the years, many cities have developed a pool of expert resources in a specific domain or process. This is particularly true in the case of Global Tier II cities that have recently emerged. Cities that have been developing expertise in one specific or more areas include Colombo (Finance and Accounting), Ho Chi Minh City (PC based applications), Moscow (Aerospace Engineering) and Krakow (Hi-Tech Engineering).

3. Multi-Sourcing will dominate as mega-deals will be sourced to a mix of Tier I and “best of breed” Tier II service providers

Many of the large contracts that are up for renewal in 2007 will be restructured considering multi-sourcing. Organizations will have a preferred set of service providers comprised of large Tier I and “best of breed” Tier II providers. Companies will also turn to smaller Tier III providers with expertise in a select niche. Large onsite service providers with no offshoring delivery capabilities will be most affected, as they will be the ones to lose their share

of contracts and will have to offshore much of what comes their way. In 2007, the number of small- to medium-sized contracts (those worth \$50-\$200 million) will see a significant increase when compared to previous years. The trend now is toward more contracts that are smaller in size with specific function. This in turn leads to the increasing use of multiple providers.



4. ITO/BPO growth will be supply-constrained in an extremely strong demand market

The demand for outsourcing services remains stronger than ever before and service providers will be facing newer challenges to meet this demand.

Service providers with predominantly onshore delivery capabilities are facing significant challenges because clients now want a significant part of their outsourcing to be done from offshore locations.

The larger players in the field will consider acquiring more companies in offshore destinations to increase their delivery capabilities and have better access to the rapidly growing market.

Service providers who do their business either predominantly onshore or offshore will start executing starkly different strategies to emerge as leading Global Service Providers. Onshore service providers will continue with to expand globally in

their search for cost optimization and to cater to the huge demand. Their ability to lead will hinge on a solid execution capability in uncharted offshore markets and an ability to beat out competition for the same talent from offshore service providers.

Meanwhile offshore service providers face challenges in the form of lack of global footprint and lack of client business / domain knowledge. Offshore services providers will try to expand into newer geographies and continue acquiring domain and business knowledge either organically or inorganically. However, their leadership will rest on their ability to manage rapid expansion and integrate newer businesses.

Market leaders in the industry will be shaped by their execution capabilities and their ability to scale up to meet the massive demand of services globalization.

5. Globally, service providers will witness a significant resource crunch

As the global demand for ITO and BPO services increases, developing countries will face a shortage of talent. This is primarily because there are a lot more players in the market, giving people a wide choice of jobs. As a result, there is an increase in both wages and attrition. China, for example, is expected to produce 3.1 million college graduates this year as compared to the 1.3 million produced in the US. However, China will have difficulty producing candidates with appropriate skill sets for the critical markets, and they will have a shortage of people who are fluent in English. As a result, only a fraction of the graduates that China provides will be suitable for employment by multinational companies in the services sector.

India also faces similar challenges. India has an estimated 14 million graduates, with 2.5 million graduates added each year. The problem lies in the fact that only a fraction of these graduates are suitable to work in multinational companies. To keep up with the market, the IT industry is hiring not only software engineers but also civil and textiles engineers. The fact that companies are essentially hiring any engineer they can find indicates a severe

skills shortage. The top four Indian ITO companies - TCS, Wipro, Infosys, Wipro and Satyam spend more than one billion dollars per year on training new staff. To add to the resources woes, the booming Indian domestic market is also competing for the same candidates. The BPO and IT companies will lose out on talent if they are not able to match the salaries and work profile provided by local companies. But if they are going to match salaries and benefits, BPO and IT companies will have to reduce profit margins, which will translate to lost savings to the client. At the same time, local companies may be willing to pay more in order to get a higher quality pool of candidates. This conflict has just recently begun for IT/BPO companies, but will increase progressively through 2007.

Firms in offshore locations will have to take creative measures in training, utilize alternative emerging locations and work with local communities to enhance educational and vocational relevance to their requirements.



6. Engineering Services, R&D Services, ERP, Infrastructure Management, Product Development and Healthcare will see increased traction in 2007

In the rapidly expanding ITO/BPO industry, there are a few sectors that are expanding more rapidly than others. Engineering Services, R&D Services, ERP, Infrastructure Management, Product Development and Healthcare are sectors that will witness growth rates beyond the industry average. Engineering and R&D Services will form a significant part of many service providers' revenues and will also contribute significantly to the total outsourcing market. The healthcare domain will see action in specific areas

like revenue cycle management as many offshore service providers gain entry into this sizeable market. Clinical trials outsourcing will also grow significantly when medical device companies begin to avail of offshore clinical trials.

Systems integration and infrastructure management are other sectors that will witness a new wave of offshoring. With offshoring attaining maturity, ERP, product development, and testing are going to have significant work move offshore.

7. Captives will see heightened activity in 2007, with parent companies considering spin-offs to cash out

Of the estimated 700 BPO companies in India and Philippines, 65% are captive and 35% are third-party vendors. More captives will be established in 2007 with the demand from the global SME segment increasing. This trend will continue in niche areas for reasons of skill availability, intellectual property and information security issues.

Over the years, many suppliers have developed skill sets in general processes and improved upon them. One reason for multinational companies to sell is that there are big global outsourcing firms that can now easily handle their needs, so maintaining an in-house unit simply doesn't make sense. Most of the established offshore BPOs have high quality of operations and cost advantages that many of the

captives lack. For mature processes, it becomes increasingly difficult for captives to recruit and retain resources in this demand driven, supply constrained market. In 2002 British Airways spun off its Indian outsourcing unit, now known as WNS Holdings. General Electric sold off its offshore outsourcing operation to two private equity firms for \$500 million. These examples suggest that many large organizations see their captives as opportunities to cash out. Similar deals seem to be in the pipeline, with names including Hewlett-Packard's Global e-Business, German publisher Springer Science and Business Media's outsourcing operation. Recently Capgemini bought out Unilever's majority stake in Indigo, a captive finance and accounting services BPO.

8. Offshoring of customer-facing processes will slow down, and some may even move back onshore / nearshore

Many companies are finding that the social costs of moving their front-end process overseas are outweighing the cost savings. This has been compounded by overly optimistic assumptions about the challenges of launching captive overseas operations. Customer dissatisfaction over perceived local job loss, and the difficulty that some customers face when trying to effectively communicate their needs to overseas workers are additional challenges beginning faced by companies.

More and more back end processes are on the radar to be sent offshore. But companies will also realize that the biggest advantage lies in having a globalization strategy that is able to procure the best skills at the best possible cost. This means we are seeing a trend where companies that have tasted success in moving higher end processes overseas will try to increase the rate of outsourcing for these services. Many companies will move beyond the hype cycle that surrounded globalization and start rationalization of their portfolios for onshore – offshore delivery fit.



9. Tier II and Tier III service providers will spread their global footprint by making significant overseas acquisitions

Service Providers realize that one of the most important elements of demonstrating competitive advantage is to have a global presence. This is primarily driven by two reasons: increasing market penetration, and acquiring client domain skills and delivery capabilities in newer geographies. Most Tier I offshore service providers have been rapidly expanding globally. In 2007, Tier II and Tier III service providers will aggressively scout to expand inorganically and will look at expanding their services to countries outside their home base.

India is the most active country when it comes to cross-border deals. There have been more than 125 cross-border deals originating from India since 2004. Some \$5 billion worth of deals have been transacted

this year, following \$4 billion in 2005. Years of high-speed growth has made many companies in India cash rich and keen to expand abroad. 70% of M&A activity by Indian companies lies with foreign companies based in North America and Europe. Most of the deals were primarily aimed at gaining market access by acquiring customers and domain skills. 2007 will see Service Providers undertaking M&A to acquire delivery capabilities, specifically in complimentary markets such as the Philippines, Vietnam and the emerging economies of Eastern Europe. Service Providers from these economies will also actively make acquisitions in India as India emerges as a must have destination for client market (US, Europe etc.) access.

10. India will continue to be the leading destination for ITO/BPO. Philippines will be a strong but a distant second, and China will trail behind for next several years

Currently there are many developing nations that act as offshoring destinations to developed nations. As the number of offshore destinations rapidly expands the world over, the country that stands out as the largest destination for offshore outsourcing is India. India commands almost 65% of the total offshoring market and is the undisputed leader in terms of the advantages that it has to offer. The Philippines is developing as a mature destination for offshoring and is a strong second for BPO with leading capability in customer service. India and the Philippines have a number of complimentary skills, especially when it comes to the BPO industry.

While 2007 will see India's stature as world's back office growing, the Philippines will evolve as the preferred destination for offshoring customer-facing

jobs based on the benefits of cost reduction, manpower availability, and quality that it brings to global organizations. Some important factors for the Philippines include: a committed and highly trainable workforce (currently the BPO industry employs over 160,000 professionals), a strong cultural affinity with the west, and the expansion of existing BPO companies such as Sykes, Accenture, Dell, PeopleSupport, eTelecare, Convergys, ICT Group, Sutherland and IBM Daksh, to name a few.

China still has a lot of catching up to do and it will be several years before Chinese services companies make their mark on the global ITO / BPO landscape.



About Tholons

Tholons is an **Investment, Advisory and Management Firm for IT, Business and Knowledge Services Globalization** who partner with companies to maximize their returns from globalization of both information technology and business processes. Their vision is to bring in the missing 'skin in the game' / 'equity participation' to deliver significant ROI to partners. Focused on a risk-reward model, the firm leads clients to develop a strategy and fund their business using investments.

Tholons professionals have made significant contributions 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. They 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 US, the UK, the Philippines and India.



For more details about Tholons' Services Globalization and Investment Advisory capabilities, please visit our website at:

www.tholons.com

You may also contact:

Avinash Vashistha

Chairman & CEO
avinash@tholons.com

Jessica MacKenzie Murthy

Director, Marketing and Public Relations
jessica@tholons.com

THOLONS Global Offices

North America Office

3130 Fairview Park Drive, Suite 500
Falls Church, VA 22042, USA
Phone: +1-646-290-9320
Fax: +1-646-349-3546

Europe Office

2 Crawford Farm, Ray Mill Road East
Maidenhead, SL6 8SU
Berkshire, UK
Phone: +44-1628-566140

Asia Office

2/10, 2nd Floor, 80 Ft Road
RMV Extension Stage II
Bangalore 560 094, India
Phone: +91-80-2351-9760

Philippines Office

46th Floor, Yuchengco Tower
RCBC Plaza, 6819 Ayala
Makati City 1200, Philippines
Phone: +632-894-9493