

# Foreword

by Stephen Dunn, Managing Principal and  
Beth Ellyn Rosenthal, Editor, Everest Group



Stephen Dunn



Beth Ellyn Rosenthal

WHEN IT COMES TO EUROPEAN SOURCING PRACTICES, THE POTENTIAL OF NEARSHORING AND OFFSHORING HAVE LATELY ASSUMED THE SAME DOMINANCE THAT OFFSHORING TO INDIA AND OTHER LOW COST LOCATIONS HAS TO THE US AND UK. LABOUR FLEXIBILITY, LOCATION ATTRACTIVENESS, THE EMERGENCE OF ASSET LIGHT IT INFRASTRUCTURE DEALS – ALL ARE KEY INFLUENCES ON HOW EUROPEAN COMPANIES ARE APPROACHING OUTSOURCING AND CAPTIVE OPERATIONS IN THE NEXT 12 MONTHS.

We see three major trends altering the landscape. The common thread weaving through the trio is how offshoring is changing the way companies outsource.

## Trend 1: offshoring and nearshoring strengthen

Everest calculates offshoring worldwide will grow 33% this year. The business case for offshoring is clear. Allianz's Indian CEO Andrew Torrance wrote in a company publication that "the benefits in terms of reducing our expense base is a powerful incentive to offshore." He said once the Germany financial services company absorbed its initial start-up costs, the company saved €5.7m a year sending work to its Indian captive.

Five different economic trends are creating a swelling demand for companies to send work outside their boundaries.

### 1. Falling unemployment rates

First is the falling unemployment rates in many core European countries like Germany. We predict this will take the political fire away from nay-sayers who are worried about job losses because of offshoring. The economic case for offshoring and nearshoring is solid but the political fallout and restrictive labour practices have been an effective brake. As more people in Europe and the UK go to work, the pressure against offshoring is decreasing.

### 2. Strengthening of the euro

The second macroeconomic trend is the growing strength of the euro. According to [xrates.com](http://xrates.com), the euro equalled Re42.965 on December 31, 2001. At the end of 2006, it had climbed to Re58.212.

The stronger euro against the rupee or other offshore destination currencies makes offshoring cheaper. For example, say a supplier pays an Indian programmer

Re450,000 a year. Given the strengthening of the euro, that salary has fallen from €10,000 to €6,000.

### 3. Exporting lessons learned

Multinational corporations who have offshored from one geography (often the US or the UK) have established the viability of the labour arbitrage and become far more conversant and comfortable with the risks. Now they are exporting these hard-earned lessons to their European divisions, asking them to step up their offshoring efforts. As a result of this knowledge of offshoring, we expect nearshoring and offshoring of multinationals from Europe to ramp up far more quickly than they have over the past five years when they took work offshore from the US and UK.

For example, AXA Group, a French financial services company, recently announced the opening of a 1,500 person call centre in Morocco with expected savings in excess of €75m annually.

### 4. Matching the competition

Many European companies are finding it difficult to compete in their marketplaces with competitors who have wrung out cost and sustained quality by offshoring non-core tasks. Today they are under increasing pressure to offshore just to match the competition.

### 5. Increasing presence of European suppliers in India and other low cost locations.

European suppliers like BT, Capgemini, and Siemens are increasing their offshore presence under pressure from competitors and customers alike. Their customers, having seen the results, are asking for an offshore component. Like it or not, they have to beef up their offshore locations to keep up with their Indian, UK, and US competition. They are also increasingly aware of, and envious of, the 20% plus net margins that many offshore providers enjoy.

## Trend 2: the list of nearshore locations on the continent is expanding

At this stage, key locations in Eastern Europe - especially Prague, Warsaw, and Budapest - have moved beyond proof-of-concept to well-established nearshoring destinations.

The Everest Research Institute's recent analysis found the 10 leading outsourcing suppliers set up about 20 new delivery centres in Eastern Europe over the last three years.

In addition to lower costs, companies are interested in sending work to Eastern Europe for two key reasons:

### The ability to access language skills at a lower cost

Eastern European suppliers are able to provide a variety of European language skills, a prerequisite for many continental European corporations.

### The growth of the EU

The inclusion of a number of Eastern European countries in the EU has generated a greater comfort in offshoring work to this region. Continental European corporations now have increased comfort with the common business and regulatory environment; this has enabled European countries to push work to their compatriots to the east.

For example, EU regulations mandate that companies can not move certain specified data outside the EU. That knocks out India and China. For these processes Eastern European countries have become the only low-cost option.

Prague has been the premier nearshoring location to date in this region. The Czech city ran into local supply and demand imbalances, wage inflation, and climbing levels of attrition among works. Fortunately, these are starting to ease somewhat, and we predict these pressures will not be as intense in 2007 as they have been since 2005. However, it still remains one of the more expensive cities in the region.

That is one reason why other Eastern European cities are seeing an increase in activity. Centres in Bulgaria and Romania as well as second tier cities in the Czech Republic, Hungary, and Poland are benefiting.

The offshore world has seen this trend before. When companies sent work to India in offshoring's early days, the suppliers were concentrated in just three cities: Bangalore, Delhi, and Mumbai. As wage increases ate into the business case, suppliers began exploring the options in Tier 2 cities like Chennai and Hyderabad. This is exactly what is happening to Eastern European suppliers.

On the business process outsourcing (BPO) side, the market has grown rapidly – more than 75% over the last three years, according to the Everest Research Institute. We believe this strong momentum is likely to continue in 2007. We predict the envelope of activity will continue to spread further east towards Russia and southeast towards North Africa.

### Trend 3: RIMO is taking off

Remote infrastructure management outsourcing (RIMO) is catching on worldwide including Europe. In January 2007, HCL won one of the biggest Indian outsourcing contracts ever, a three-year asset-light deal with electronics retailer DSG, best known for its Dixon's stores in the UK.

Traditional IT transactions always included transferring ownership of IT assets along with operational responsibility to the supplier. Buyers considered removing the assets off their balance sheets a prime source of value. But both buyers and suppliers found it was difficult to specify the kind of assets needed over the course of a 10-year agreement since technology tends to change at warp speed.

Historically, assets ownership transfer to a supplier was an integral part of an infrastructure outsourcing (IO) engagement. Outsourcing suppliers needed to own the assets to deliver the benefits of the outsourcing to the buyer, i.e.

- Financial benefits (e.g., one-time cash infusion, increase in return on assets) were contingent on the transfer of the assets off the buyer's balance sheet, which required the change in ownership.
- Operational benefits (e.g., cost savings from improved operations, benefits of additional scale) required assumption of the control over assets and proximity to them.

Enter the asset light model, made possible by offshoring. In this version, the buyer continues to own and control the assets while the supplier assumes the operational responsibility. Offshoring instead of asset ownership

becomes the source of the savings. This model is gaining in popularity because buyers have full transparency over the price of the assets. Also, they can take out cost and achieve their business case cost savings faster because all it involves is moving the labour offshore. The model provides a better alignment of the supplier's incentives with a buyer's goals. As a result, buyers can achieve the majority of the benefits of outsourcing without change in the ownership of the IT assets.

Suppliers, in turn, see the asset-light model as a solution to their struggle to make the economics of the asset-based outsourcing work for them. Increased capital expenditure requirements in asset-heavy deals coupled with the shortening of the average deal duration in IO can seriously diminish return on investment (ROI) for the suppliers.

New technologies serve as a catalyst for the asset-free approach. They prove more susceptible to the asset-light approach due to the constant change of the asset base and the difficulty of predicting the technology road map. In such conditions, the common output-based pricing model (e.g., price per server, price per MIPS) typical for the asset-heavy deals fails to adapt to the changing nature of the assets base, prompting departure from the asset-based pricing and adoption of alternative models.

Finally, the arrival of new, primarily offshore RIMO-focused suppliers makes this all possible.

We predict that RIMO market, which is approaching US\$1bn today, will grow to over US\$8bn in the next five years further promoting asset-light outsourcing model.

This growth will come from two sources: expansion of the outsourcing market from the entry of the new buyers that were avoiding outsourcing based on the traditional model and the new RIMO entrants successfully competing for the new outsourcing business and renewals of existing clients.

This shift from asset-heavy to asset-light deals will lead to a sizable decline in outsourcing revenues. We observed that when RIMO suppliers win the deal competitively, the contract size ends up being two to three times smaller than it would have been if

a traditional supplier had won the deal due to the exclusion of the assets. We call this phenomenon asset deflation of the outsourcing deals.

Although this trend is clearly troubling to many traditional outsourcers, they are also building strong RIMO capabilities

to prevent the dramatic market share loss experienced in application development and maintenance (ADM) from occurring again.

What will happen next year? The only certain thing is outsourcing will become even more global.