The Impact of the Global Economic Downturn on Outsourcing and Offshoring

Implications of Changing Needs and Evolving Competitive Landscape

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Executive Summary

Economic uncertainty was a key inhibitor to outsourcing growth during 2008. Client executives usually consider outsourcing as an option to reduce costs or enhance growth. The onslaught of mixed economic indicators throughout 2008 kept executives wondering whether to cut costs. The uncertainty brought decisions to a dramatic halt.

Now that the U.S. economy is "officially" in a recession along with a dire outlook for 2009, the prospects for outsourcing, ironically, appear much better. The negative economic outlook remains discouraging; but the greatest hindrance to outsourcing is uncertainty, and the economy is finally moving beyond that noncommittal midpoint.

In preparation for a difficult 2009, executives are evaluating programs they can prune, investments they can postpone, and projects they can terminate without impacting company strategy. Given that most companies outsource at least one operation, it is natural that some outsourcing contracts will be partly reduced in size or scope as part of this adjustment.

In 2009, Everest Research Institute believes that increasing numbers of companies will take a more strategic view of operations. Companies will examine methods to reengineer business processes or to restructure back-office operations, resulting in an increasing number of outsourcing opportunities during 2009.

As the economy recovers, Brazil can play a stronger role in providing globalization services to the United States and Europe. With its cultural and geographical affinity to the United States and Europe, Brazil can be an alternative to India as globalization matures. Rather than displacing India, however, Brazil should expect to become an alternative for risk diversification, competing with Eastern Europe and China. Brazil must demonstrate how it can integrate into a global delivery structure rather than compete directly with India.

Brazil's domestic market is also likely to see some increased competition as outsourcing players from around the globe seek new growth markets. Both the nature of competition and the industry structure may evolve as players seek to compete more aggressively for business in Brazil.

This report examines the following topics:
- U.S. and European market pressures
- Impact on service exports
- Impact on Brazilian domestic market

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U.S. and European Market Pressures

With 2008 in the rear-view mirror, the U.S. outsourcing market faces a critical year in 2009. Patterns from previous recessions plus the addition of offshore labor arbitrage (the most powerful cost-savings lever to ever impact outsourcing) suggest that it will be a year of recovery and growth for the outsourcing sector. Europe is less experienced in adopting outsourcing, but similar trends are expected to emerge – particularly given the increased use of outsourcing in Europe during 2007 and 2008.

This section examines the dynamics of:

1. Changing corporate behaviors
2. Outsourcing supplier responses to the economic pressures
3. U.S. political environment for outsourcing and offshoring

Changing corporate behaviors

As is expected during a time of significant economic pressure, corporations are emphasizing cost reduction and containment. Although this places downward pressures on outsourcing spending, there are some motivations for spending more on outsourcing or spending differently. This report addresses the dynamics of different types of spending in detail in the next section ("Impact on service exports").

In Everest Research Institute's conversations with market players (both corporations purchasing outsourcing services and the leadership of organizations providing services), the following behaviors are noteworthy dynamics:

- **Staff reductions.** To cope with the extreme and rapid pressures of the eroding economy, many corporations have already reduced their internal staffing levels. Financial services led the way in late Q3 2008, but many others joined during Q4 2008. In some extreme cases, companies cut overnight the personnel managing the receipt of service from outsourcing suppliers, and suppliers were left to find new internal contact points. Although most cuts will not be this rapid, resources engaged in governing external relationships are often the focus of staff reductions (governance expenses are notoriously prone to budget cuts).

- **Decision-making gyrations.** The combination of uncertainty and change (e.g., who makes the decision when the previous person was let go?) slowed decision making during Q4 2008. As organizations entered into extreme periods of uncertainty and change, it was common for them to almost freeze day-to-day decisions while waiting to see what impact the stock market, central banks, politicians, or industry restructuring might create. However, this period of significantly slowed decision making can last for only several months. At some point, managers tire of the paralysis

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and realize that they must act and cannot wait for perfect clarity, and their superiors will favorably view their actions to make improvements (or may not have time to notice how they spent their few remaining budget funds). Additionally, senior management eventually re-aligns its focus to begin driving new initiatives aimed at preparing for and surviving the recession. Everest's experience has been that most organizations are only in the period of extreme uncertainty for two to three months. As organizations exit the period of uncertainty, not only can they improve decision-making but they can also be bolder and more rapid than expected – the need for speedy impact is significant. Many financial services organizations seem to have exited the period of extreme uncertainty and are now moving forward and operating in a more predictable manner. Automotive companies may also be coming out of their own period of uncertainty during Q1 2009, as will most other sectors that acknowledged the inevitability of the recession during Q4 2008.

- **Payment term flexibility.** In a recession marked by a significant credit crunch, it is not surprising that organizations are spending increased attention on managing payment terms. Some organizations are casting aside industry norms of net 30-45 days. Organizations under extreme financial pressure are even using leeway on payment terms to select between suppliers. For those seeking payment, this poses some interesting dilemmas with no easy answers.

- **Simple value propositions.** With the need for speed and the desire to carefully control risk, organizations prefer simple value propositions. Simple value propositions make it easier for companies to understand the value, attain organizational support, and make it less risky to implement the solution (or at least are perceived as such). Additionally, services and technologies that are easier to manage with less staff or better integrate with other systems/processes are also attractive. Companies generally perceive transformative value propositions as risky, both in terms of financial requirements and inability to create the sustained organization focus to drive them to completion. However, companies can view positively value propositions that provide the option (but not the requirement) for future transformation.

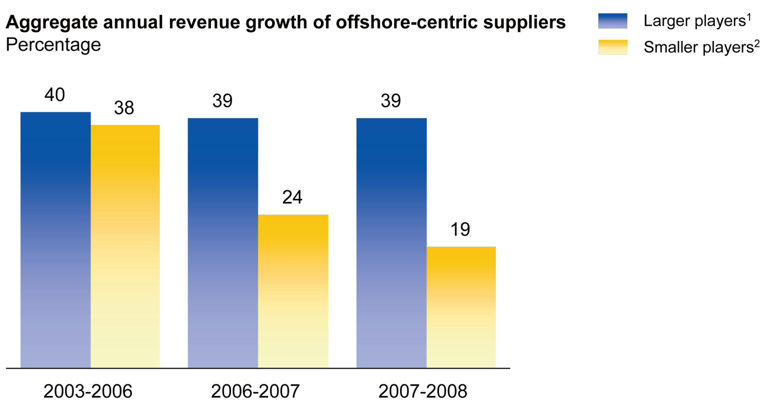
- **Using near-term change to support longer-term strategy.** Organizations often have strategies that they struggle to implement because changing the existing order of things is not worth the perceived benefit. Counter to some of the points discussed above, this period of economic turmoil will be a key time for organizations to implement some of these meaningful changes – particularly when several modest, incremental changes add up to a larger, more fundamental change. Catalysts such as acquisitions, divestitures, and restructurings provide an opportunity to adjust the scope of outsourced and offshore work, realign the portfolio of suppliers, and refine the global delivery footprint. The November 2008 terrorist attack in

Mumbai provides further motivation for making near-term decisions in a manner that helps diversify location-related risks. Everest Research Institute expects that larger outsourcing suppliers with strong offshore value propositions and established reputations will tend to gain market share in the coming quarters. Conversations with some of the leading players indicate that although their revenue growth was not as strong in 2008, their pipelines are quite strong – in some cases, stronger than at any previous time. Everest believes that this is due to "buyer-driven supplier consolidation" or the shifting of work to fewer and larger suppliers as buyers realign their sourcing efforts. Although this dynamic has been revealing itself in the revenue growth rates of leading offshore players for several years (**Exhibit 1**), the pace of separation from others in the market is likely to grow as buyers further optimize their portfolios during the economic recession.

EXHIBIT 1

Comparison of revenue growth rates of larger and smaller offshore-centric outsourcing suppliers

Source: Everest Research Institute



1 Cognizant HCL, Infosys, Satyam, TCS, Wipro
2 Hexaware, Mastek, Ness Technologies, Patni, Polaris
Note: The analysis of supplier revenue growth trends is limited to offshore IT-centric suppliers with limited acquisition activity. These suppliers have attempted to grow revenue primarily through deeper penetration in IT services and many attempting to expand into BPO offerings

Some unique factors will influence each corporation's behavior and how it will make trade-offs. To spot opportunity and risk, buyers should start by looking at the implications for each organization from combining staff reductions, decision-making gyrations, payment term flexibility, simple value propositions, and use of near-term decisions to support longer-term strategy.

Outsourcing supplier responses to economic pressures

Over the course of 2008, outsourcing suppliers adjusted to match the changes in the marketplace. Three areas of adjustment that are particularly important include:

1. Hiring decisions
2. Pricing trends
3. Business diversification

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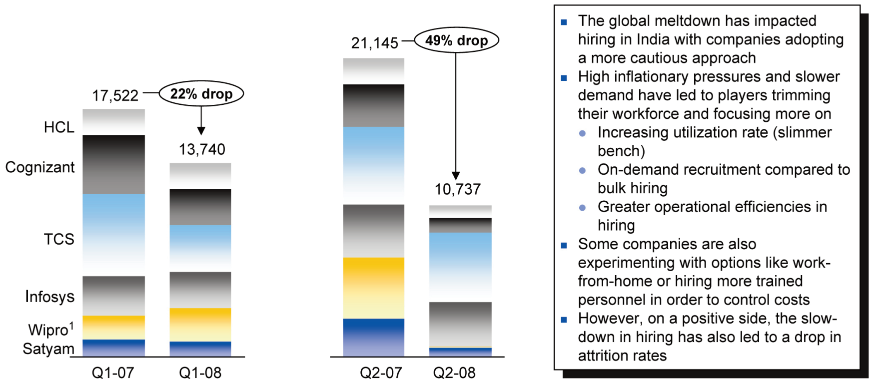
Hiring decisions

In contrast to recent years, the leading offshore players scaled back their recruiting efforts (**Exhibit 2**). A combination of reductions in discretionary projects, lower employee attrition, and softer overall demand diminished the need for incremental employee growth. Additionally, suppliers are absorbing the large benches of un-utilized (or under-utilized) resources or trimming them to more closely match the net-new demand versus building large capacity in advance of expected demand.

EXHIBIT 2

Hiring trends for SWITCH companies

Sources: Everest Research Institute; Supplier Websites



1 The net addition of employees for Wipro does not include employees in the India/Middle East IT Services category

Although the caution related to hiring will likely continue for several more quarters, as the market recovers and suppliers reduce benches, hiring rates for the larger players are likely to increase. Overall hiring may not match historic levels (which also helps mitigate wage inflation). But riding on the buyer-driven supplier consolidation force mentioned earlier, the larger offshore players are likely to hire at rates exceeding market averages. Early reports are that Infosys and TCS modestly increased the number of offers to 2009 graduates over the number of offers extended in 2008.

Traditional outsourcing players such as HP/EDS, IBM, CSC, and Accenture will continue to shift more work offshore. Those that did not make significant progress on building offshore delivery before the economic turmoil (CSC, EDS) will be fighting to shift quickly. Further, smaller, traditionally onshore outsourcing suppliers are forced to create an offshore delivery capability – either via their own delivery centers or through partnerships with other players. These dynamics will result in work force reductions in high-cost markets and increases in lower-cost markets.

Pricing trends

Client reductions in discretionary spending combined with the U.S. financial crisis appear to deflate pricing for globalization services. As companies across the United States and Europe deal with financial losses or even bankruptcy, it becomes unconscionable to pay rates that allow for 20+% profit margins, even if those suppliers are halfway around the globe.

Large customers are demanding (and receiving) price concessions, even from SWITCH suppliers (i.e., Satyam, Wipro, Infosys, Tata, Cognizant, and HCL). These suppliers traditionally were resilient to market demands due to their size and high growth rates.

Companies are beginning to feel the impact in India. Employees can no longer count on double-digit raises between jobs; in fact, the rules of deflation predict that salaries will actually decline and there is early evidence of this occurring in some situations.

The economic pressure on the industry market may demand a more precipitous reduction in pricing than previously expected

The economic pressure on the industry market may demand a more precipitous reduction in pricing than previously expected. While deflation should be a temporary lull in market pricing (i.e., eventually prices will increase again as offshore costs also increase), the results will last for years and could permanently reset offshore margins to lower levels. More favorable exchange rates for offshore-centric suppliers and softening operating costs will partially offset the trend toward lower margins.

A final important trend to watch is the potential move towards output-based pricing (e.g., per invoice processed, per supported server) and away from FTE-centric pricing (e.g., per clerk per hour, per programmer per day) for offshore services. This shift received significant attention and is likely to occur with increasing frequency. However, this is complicated for both the client (i.e., may be more difficult to predict/control budgets versus simply controlling the number of FTEs) and the outsourcing supplier (i.e., requires taking on more operating risk and increased sophistication of cost modeling). Combined with the need to act quickly, Everest expects this trend to have a modest impact on pricing behavior in the market in the coming one to two years. However, more advanced experimentation with this shift will occur, creating successes and failures which will influence future decisions.

Business diversification

The dramatic growth rates of offshore outsourcing services in the last five years led the leading offshore players to the conclusion that maintaining the stock price valuations they have enjoyed would necessitate developing additional growth engines beyond just offshore applications development and maintenance. Over the course of 2005 through 2007, this conclusion resulted in launching a myriad of new services lines (e.g., remote infrastructure management, BPO, engineering services, KPO) and industry and geographic expansion. Much of the industry and geographic expansion occurred through small acquisitions of consulting firms, small service suppliers, and other "tuck-in" acquisitions.

In 2008, the focus of acquisitions began to shift to making "big moves" – either by acquiring large services businesses (HCL acquiring Axon for $880 million) or acquiring offshore captive operations (WNS and Aviva BPO, TCS and Citi BPO). Many of these acquisitions were funded with the cash accumulated from a high-margin business and attractive stock multiples. The remaining cash reserves now serve as valuable options to purchase assets during a time when cash is particularly valuable. As a result, Everest believes that during the first half of 2009, there is a window during which some unique transactions are likely to occur, which will further help offshore players diversify their businesses.

U.S. political environment for outsourcing and offshoring

While politics played an important role in globalization prior to the 2004 elections, the current impact is much less significant. Even the promises of President-Elect Obama lack the fervor or charged accusations from years ago. In short, Everest does not believe that the U.S. political environment will meaningfully impact the outsourcing and offshoring markets.

Beyond Everest's own experience and predictions of the political landscape, Bernstein Research[1] offers a similar opinion (*IT Services: What Will U.S. Politics/Legislation Do to Corporate Taxation, Visas, and the Offshore Trend?*, by Rod Bourgeois, Bernstein Research, December 2, 2008).

Bernstein Research opinions

Bernstein's research suggests: "… future U.S. anti-offshoring policy is more likely to produce useful political 'talking points' enabling politicians to claim they've moved legislation that eliminates tax breaks for companies that ship jobs overseas. However, we are doubtful that the actual policies behind these talking points will substantially detract from offshore services demand. In other words, we think U.S. anti-offshoring policy ideas are effectively targeted to U.S.-based multinational companies enjoying tax advantages through their foreign subsidiaries, but they do not appear to target the practice of hiring offshore/Indian firms to handle services functions." As a result, demand for offshoring services is unlikely to be meaningfully impacted by these policy changes.

It is also important to bear in mind that the offshoring topic is broader than offshoring of services jobs – it also includes the much larger segments of offshore manufacturing and textile jobs. The breadth of companies with a motivation to maintain offshore operations is significant and likely to pose a serious challenge to any attempts by the U.S. government to reduce offshore efforts.

1 Rod Bourgeois of Bernstein Research is the top-ranked analyst covering the IT services sector and regularly collaborates on research topics with the Everest Research Institute.

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In addition to potential changes to the tax code, the U.S. government might choose to modify visa regulations and oversight, which can impact the ability of offshore workers to travel and work temporarily in the United States. However, any changes in this area are likely to be part of a broader immigration reform and are unlikely to be a top priority for the new administration in 2009. Further, any efforts to directly target offshoring of services (e.g., mandating offshore/onshore mix for U.S. outsourcing contracts) are likely to be very complicated, and Bernstein has "not found efforts to legislate a staffing mix on outsourcing deals to be focal points of U.S. policy discussion."

Finally, the degree to which the U.S. government chooses to pursue anti-offshoring efforts will be mitigated by "counterarguments favoring free trade and promoting U.S. competitiveness in overseas markets." In addition to the generally increased acceptance of foreign trade in the United States (i.e., less protectionist policy despite the rhetoric), the increased Democratic presence in the U.S. Congress tends to be more fiscally conservative than traditional Democratic positions and therefore less interested in restricting trade. Interestingly, Obama's choice for U.S. trade representative (a cabinet-level position), Ron Kirk, is a Democrat with a strong pro-trade history, who acted as an active champion of NAFTA and international trade while serving as major of Dallas, Texas in the 1990s.

Summary of U.S. and European market pressures

In summary, companies are clearly positioning for near-term reductions based on general spending cuts across the United States and Europe for 2009. Outsourcing suppliers are not immune from cuts to programs or projects. Clients will still be interested in new solutions that provide short-term cost savings (within three to six months) and many corporations are beginning to focus on coordinated cost-cutting efforts as they enter 2009, which should provide a boost for outsourcing demand. In the longer term, companies will use the recession as a time to prune business models and to restructure internal operations. Outsourcing suppliers are adjusting hiring plans, carefully watching pricing trends, and seeking opportunities to diversify their business. While politicians can sometimes intervene in globalization initiatives, government watchers do not anticipate significant changes within the foreseeable future. As a result, Everest sees the U.S. and European outsourcing market poised to grow in 2009, but with forces that vary by the type of spending decisions.

Impact on Service Exports

Everest Research Institute believes the best approach for evaluating the U.S. and European market for outsourcing is by assessing the impact of three types of spending decisions. The three types of spending decisions include:

1. **Discretionary spending.** Corporations will make near-term cuts to prepare for reduced budgets in 2009. Budget cuts impact discretionary spending – spending that companies can eliminate without impacting the day-to-day operations of the functions.
2. **Non-discretionary spending.** Companies will evaluate non-discretionary spending. This funding “keeps the lights on” and involves costs around how a company’s core business operates. Cutting these funds means that the company must make fundamental changes to how the work is performed, and outsourcing may become one option.
3. **Strategic restructuring.** Corporations will examine methods to restructure current business operations. These changes range from pruning unprofitable businesses to reengineering business processes. Outsourcing can be a pivotal change agent for such initiatives. In the case of acquisitions or divestitures, outsourcing can play a prominent role in enabling the resulting organization.

Discretionary spending

The global economic climate leads most companies to focus on reducing discretionary spending for 2009. For most IT organizations, the overall level of spending that is "discretionary" is relatively small, usually less than 10 percent. For existing outsourcing efforts, this percentage is typically larger because organizations often outsource a disproportionate amount of their “project” work.

In many cases, business units that are funding specific projects provide the discretionary funding. The business unit often makes decisions on how they allocate that money or whether they remove the funding. Many IT organizations have steering committees comprised of business unit executives. The steering committee prioritizes projects and makes collaborative decisions regarding cost reductions. Thus, while discretionary spending seems like a good area in which to cut IT operating costs, the CIO frequently does not control the decisions. Short-term reductions will focus on two areas: postponing decisions for new projects and emphasizing costs to a disproportionate level.

Postponing decisions for new projects

While the IT organization may not be the final decision maker for a project, it must comply with the budgetary constraints of business units or steering committees. Companies will likely postpone (rather than cancel) any projects that are not critical to current operations or business initiatives. These projects

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can vary from infrastructure upgrades to application development.

Emphasizing costs to a disproportionate level

While procurement offices normally attempt to balance quality and time schedules along with cost, they become highly focused when cost-reduction messages dominate company policy. Procurement processes will include supplier comparisons and requirements that the supplier carry transition expenses along with promises for immediate cost reductions. In some cases, Everest has seen contracts that require the supplier to accept price concessions, regardless of whether operational costs can be eliminated.

Although much of the momentum on discretionary spending is towards less spending, this is not universally true

Although much of the momentum on discretionary spending is towards less spending, this is not universally true. Through Q2 2009, successful outsourcing suppliers will convey messages throughout the sales process that emphasize their ability to reduce costs and allow client control as a pivotal element of the contract. Not only will clients want aggressive cost reductions, but they also will want the ability to shift control when the mandates for cost reductions change. Thus, executives will want the ability to change contract terms and services as corporate priorities change throughout 2009 (and beyond).

Suppliers from Brazil should focus on the basic tenets of sales tactics and offer solutions that are not priced in terms of full-time equivalents (FTEs) or based on labor effort. Such pricing mechanisms work in the favor of India-based suppliers with lower cost structures and labor prices that cannot be matched in Brazil. Solutions from Brazil should be shifted to alternative pricing models such as results-based pricing, per-unit pricing, output pricing, or even fixed-cost projects. In addition to shifting the customer's focus toward business results or impact, these pricing models help diffuse the tension of competing directly with India. However, the value propositions must be easy to understand and attain organizational agreement.

Non-discretionary spending

Funds that companies classify as non-discretionary pay the day-to-day maintenance of running the IT organization or business processes such as human resources or finance and accounting. In most cases, these services are critical operations to the company's continuity (e.g., payroll, billing systems, financial reporting) and do not vary much month to month or year to year. This stability is one of the key attributes of the outsourcing sector that attracts the investment community.

For existing relationships and revenue streams, some suppliers will see decreases in volumes as overall business volumes decrease. However, some suppliers are seeing notable increases in volumes (e.g., fraud detection, bankruptcy filings, exception check processing, and other processes and

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systems protecting and ensuring cash flows). Identifying and seizing these opportunities is critical to organically growing existing relationships.

For inorganic growth, it is important that suppliers consider what types of value propositions will attract interest in outsourcing new non-discretionary spending. When executives are unable to make internal changes to critical services or afford the investments required to make improvements, they will always be interested in proposals that will make the service:

1. More efficient
2. Less expensive
3. More impactful

Any proposals should communicate the client's benefit in terms of dollar savings plus any other non-financial benefits.

Improving efficiency

In the long-term, every manager and executive is interested in doing the same work more efficiently. The failure to continuously improve resulted in the failure of many otherwise successful companies. An outsourcing supplier is at an inherent disadvantage as it attempts to tell executives how to run their business. Sales teams will always be welcome to present operational improvements, but they will only have one chance to submit substantive thoughts.

Reducing costs for existing contracts

As the market for outsourcing expanded, most companies outsourced at least one operation. As executives face corporate mandates for reducing costs, they inevitably turn to suppliers with existing contracts. Outsourcing suppliers should expect customers to discuss ways of driving costs out of current contracts, in some cases accepting concessions for lesser services. The ability of a supplier to articulate cost/benefit trade-offs will determine its credibility as a business partner.

Impacting business results

Improved alignment of information technology with business results was the pursuit of CIOs for decades. Suppliers that can offer innovative solutions to improve alignment and efficiency will always be welcome in executive offices. Similar to efficiency proposals, a sales team has only one chance to influence the client.

For services that directly relate to business activity (e.g., check processing), most executives become attentive listeners when discussing strategies for transitioning fixed costs to a variable cost structure. In the example of check processing, a bank would prefer to pay a fixed price per check rather than a fixed fee per month. While other industries (such as manufacturing) prefer fixed costs, most Banking, Financial Services, and Insurance (BFSI) companies are keen to shift toward variable costing. The difference is simply the degree of variability in revenues. Most manufacturing firms have more steady revenue streams with lower profit margins, making predictability of utmost importance.

Brazilian players should target niches that are sufficiently large to provide significant growth for Brazil, even if the market would be too small to support Indian or global markets. In particular, the most attractive areas are those for which Brazil can provide solutions that leap-frog existing technologies with low-investment. In the past, corporations were reluctant to force change upon their customers; however, there is a greater willingness to consider implementing more efficient and effective solutions which were previously considered too disruptive.

Strategic restructuring

While executives are primarily focused on short-term cost reductions, they are beginning to evaluate longer-term, strategic changes – particularly those organizations impacted by acquisitions and divestitures.

Business units will reengineer processes and systems, finding ways to eliminate waste from current internal processes and more efficiently support business requirements. The key to these changes is “process,” which is a subject in which most global suppliers excel. The ability to coach a client on how to change operational processes and leverage labor arbitrage to reduce the total cost of supporting the process will be a winning offering in 2009.

A key challenge of outsourcing is that most projects require over six months to show a return on investment. Major initiatives can require as long as 18 months before the client recognizes cost savings.

The interim costs include the work of selecting a supplier, the effort of transferring assets (people or otherwise), the cost of the supplier’s learning curve, and finally the ability to reduce internal services and shift entirely to the supplier. This "cost curve" is one key reason that many companies did not "pull the trigger" on outsourcing during 2008: any initiative begun after June 2008 would likely not have resulted in a financial impact until 2009 and might have even cost more money.

As 2008 concluded and the recession became unavoidable, companies moved from focusing only on avoiding near-term losses to considering efforts that will provide significant medium to longer-term financial benefits. Tolerance for investment is low, but in some cases companies can capitalize these investments, thereby making more significant near-term changes feasible. In particular, companies with post-merger initiatives will demonstrate an appetite for meaningful changes to existing processes and systems.

As 2008 concluded and the recession became unavoidable, companies moved from focusing only on avoiding near-term losses to considering efforts that will provide significant medium to longer-term financial benefits. Tolerance for investment is low, but in some cases companies can capitalize these investments, thereby making more significant near-term changes feasible. In particular, companies with post-merger initiatives will demonstrate an appetite for meaningful changes to existing processes and systems.

One interesting outcome of restructuring efforts is that they will generate discretionary spending projects, which will offset some of the original decrease in discretionary spending. Companies being at the right place at the right time becomes critical, and careful account planning can help position for these opportunities.

Additionally, as described earlier, many organizations will seek utilize restructuring efforts to further the implementation of previous outsourcing strategies that were difficult to implement in times when hard decisions were not as common. In particular, companies will more aggressively pursue decisions regarding delivery center locations and scope of services.

When positioning for assisting on initiatives that are directly or indirectly a part of restructuring, Brazilian players should carefully leverage the implications of two factors that can be used to their advantage:

1. Geographic diversification
2. Industry specialization

Geographical Diversification

A key strength in the current globalization market is being "not India." As India dominated industry growth for nearly a decade, it suffers from its own success. Whether the issue is turnover, inflation, or cultural affinity, India has growing pains.

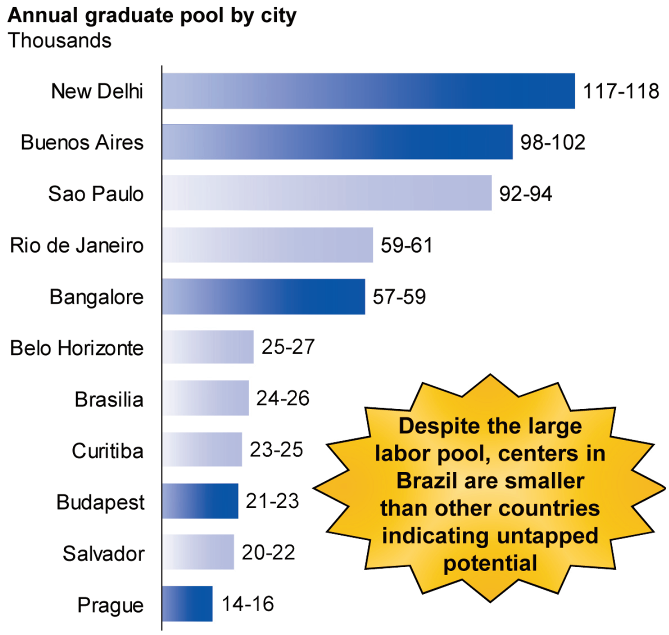
Most organizations accept that they will receive a significant portion of their services from India but are not comfortable with being as heavily dependent upon India as they feel today. The November 2008 Mumbai terrorist attack and resulting escalation of tensions between India and Pakistan only stiffened the resolve of companies to guard against over-concentration in India. Against this backdrop, a current asset in the market comes from being "not India."

As detailed in **Exhibit 3**, Brazil has the fundamental labor pool size to compete against leading offshore destinations. Although size is not the only factor of importance, outside of Asia, there are very few countries and cities that can provide large, talented labor pools.

EXHIBIT 3

Comparison of annual graduate pools for leading offshore cities and Brazilian cities

Sources: Ministry of Education for each country; Regional statistics agencies; Everest Research Institute



Companies are investing in "not India" to diversify their globalization risk. Many corporations expressed to Everest that they have "all their eggs in one basket" with their entire globalization strategy and assets located in India. They want to diversify their risk and develop alternatives to India. Whether the location is the Philippines, China, Brazil, Mexico, or Eastern Europe, they often initially focus more on "not India" than the actual location.

In this context, Brazil is not competing directly with India but, rather, trying to present itself as a beneficial complement. It is being evaluated based on its ability to interact and to integrate with a client's existing Indian operations. Brazil competes with other geographies that are alternatives to India and, as such, can best demonstrate its value by showing how it aligns with India rather than contrasts with India.

Brazil currently and will continue to export services around the globe. Opportunities for Brazil vary, based on market segments or language (i.e., Japanese) to domestic strengths (e.g., natural resources). Currently, suppliers in Brazil depend primarily on the domestic market, exporting only five percent of resources (**Exhibit 4**). As Brazil looks for ways to increase its export potential, it must first understand the changing corporate mindset regarding offshore destinations and identify the roles it can play in helping organizations diversify their location footprints.

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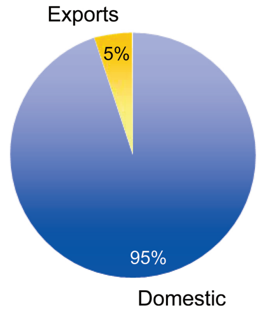
EXHIBIT 4

Composition of Brazil's IT services industry

Source: Everest Research Institute analysis



Industry Strength

Brazil has a strong reputation in banking and telecommunications. The intersection of these industries currently creates a significant market for mobile banking (in all facets such as trading and security). Brazilian suppliers could benefit from targeting these opportunities, leveraging Brazil's strength, and establishing a niche in which India would lack equal credibility.

Brazilian suppliers could equally emphasize expertise in petroleum and natural resources, in which its inherent assets would establish (near-) immediate credibility. Neither of these markets would be sufficient to attract significant competition from the Indian supplier community. Further, Brazil also has internationally recognized expertise in SAP support; combining this with industry expertise can be an attractive value proposition.

Impact on Brazil Domestic Market

As the global economy faces significant pressures in 2009, Brazil's domestic outsourcing market may experience some residual impact on competition and industry structure. Although there are several factors that suggest increased pressure in both of these areas, other factors that will limit potential changes.

Impact on competition

As growth prospects in the United States and Europe slow for many outsourcing companies, they will increasingly look to other geographies for growth opportunities. In addition to seeking growth opportunities, many companies also seek to diversify their geographic customer base.

Based solely on its size and relatively mature economy, Brazil is fairly high on the list attractive markets. Companies seeking to serve Brazil will typically focus on the largest organizations operating there – both those originating from Brazil (e.g., energy, banking, communications, etc.) and foreign companies with large operations in Brazil (e.g., energy, automotive, etc.). As a result, competition for well-known logos will increase.

Large, traditional players like Accenture, EDS, IBM, and Unisys will continue to try to grow their business in Brazil. However, the global economic conditions are not likely to generate increased focus on Brazil; if anything, the poor economic conditions might limit the ability to invest.

Leading Indian offshore players (e.g., Infosys, TCS, Wipro, etc.) are more likely to increase their efforts in Brazil. However, the relative degree of effort in comparison to other priority geographies may be less for Brazil. Europe matured into a larger and better market for outsourcing services, and many Indian players are trying to build out their businesses across continental Europe.

Additionally, Indian players found recent success in the domestic India market (which many had previously ignored) and the Middle East. In both India and the Middle East, the Indian players are operating in regions that are very comfortable for them (e.g., proximity, culture, business practices, etc.) with significant economic growth that often requires access to talent to support the implementation and maintenance of new systems and platforms (e.g., mobile phone, banking, retail, etc.). By contrast, Brazil is a less natural market for the Indian players (distance, language), lower growth (already more mature and sophisticated than these emerging markets), and has ample access to technical skills and platforms that it developed for Brazil.

When Indian players do compete in Brazil, the nature of their value proposition will be different than in other geographies. The following are some of the key differences:

- **Minimal role of labor arbitrage.** Due to the cost structure of Brazil, language requirements and local labor laws trying to shift large numbers of jobs to lower cost geographies will not be the foundation of the Indian value proposition.

- **Limited attempt to synergize Brazilian market development with other North and South American markets.** In some other markets (e.g., Mexico, Canada), Indian players used their local presence to serve the United States from a nearshore delivery center and to enter the local market. In Brazil, the opportunity to leverage a local delivery presence to serve other countries will be more limited due to both language differences and labor laws. As a result, Brazil-based delivery centers will focus primarily upon serving the Brazil domestic market.

- **Greater emphasis on the role of product with the service.** The limited role for labor arbitrage will increase the extent to which Indian players will need to compete based upon offering products versus pure services. Examples include BPO transaction-processing platforms, banking platforms, and embedded software. However, unlike the transformative solutions that suppliers typically provide to emerging economies (product provides a complete new service enabling a leap forward in technology sophistication), the offerings in Brazil will likely need to be more incremental and compete against other strong offerings. As an example, providing a mobile phone infrastructure (e.g., systems, customer support, etc.) will not be as valuable in a more technically advanced market like Brazil.

Among the leading Indian players, TCS is likely to be one of the most aggressive in targeting Brazil due its focus on developing the Latin America market and comfort/synergy with serving markets that are attractive to other Tata business segments (vehicles, steel, etc.).

Although Infosys and Wipro are likely to compete in Brazil, their approaches are likely to be less pervasive than TCS. Infosys relies heavily on an India-centric labor arbitrage value proposition, which will not be as beneficial in serving Brazil. When Infosys does compete, it will likely be related to its major products (e.g., Finacle for core banking) or its consulting services. Wipro also has platform investments (although far less packaged than TCS or Infosys) which it could leverage to serve Brazil; but it is more heavily focused on serving India and the Middle East as growth markets and made large acquisitions (e.g., Infocrossing in the United States for IT infrastructure, Citi IT captive in India) to become a more sizable player in its existing markets.

Other players to monitor include Satyam and Tech Mahindra. Next to TCS, Satyam is the most aggressive in operating outside of the United States and Europe and has already established a presence in Brazil. (Note: Satyam's troubles in December 2008 and early January 2009 are likely to have a significant impact on Satyam and its ability to continue to compete.) Tech Mahindra heavily focuses on the telecommunications sector with a strong suite of products and services, originating from a close partnership with BT and resulting in a broad range of telecommunications clients. HCL Technologies and Cognizant, two other leading Indian players, have not articulated strategies or taken actions which suggest they will target Brazil as a market for new business.

Impact on industry structure

In addition to Brazil's domestic players and the global majors that operated in Brazil for many years, some India-based players now vie for Brazil. Many of the Indian players accumulated large cash reserves and continue to maintain very aggressive revenue growth objectives (20 percent or more per year). As a result, there is a possibility that Indian players in particular may look to acquisitions as a way to solidify and speed their presence in Brazil.

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Alternatively, some may look to create close partnerships that would help them operate more effectively in Brazil.

As illustrated in **Exhibit 5**, the number of acquisitions in the IT outsourcing industry climbed significantly in recent years. However, very few of these acquisitions were in Latin America. Instead, suppliers focused on North America and Europe. The objective of these acquisitions was to:

- **Fill gaps in the service portfolio.** Service portfolio acquisitions focus on attaining unique intellectual property or function-specific skills (e.g., remote infrastructure management). These are the largest portion of acquisitions, representing 36 percent of IT acquisitions.

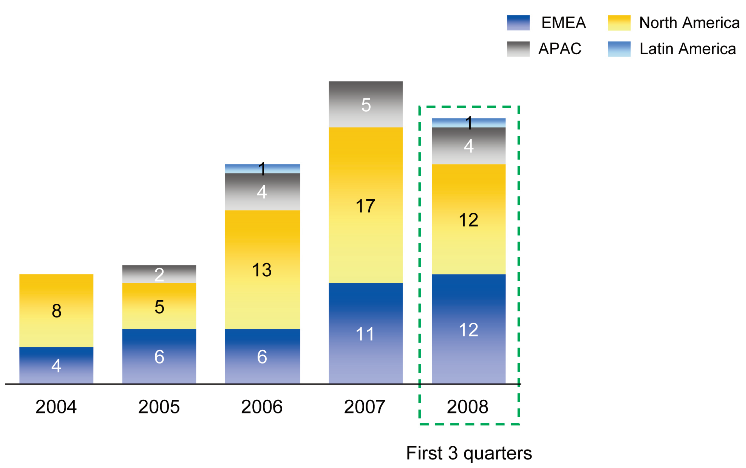
- **Acquire industry-specific skills.** Representing 35 percent of all acquisitions, companies intend these efforts to capture pre-existing industry-specific skill sets that provide rapid credibility within an industry sector.

- **Expand into new geographies.** The third largest volume of acquisitions (representing 19 percent), focuses on providing a foothold in a new geography. The intent is to both acquire access to new customer bases and expedite the process of learning how to operate in a new region. (Note: acquisitions focused just on expanding the customer base without also representing a new geography are rare; customer base expansion is only a common objective when accompanied by access to a new geography.)

EXHIBIT 5

Annual distribution of number of IT outsourcing acquisitions by geography

Source: Everest Research Institute



If acquisitions occur in Brazil, Everest expects that they will fall into one of two categories:

- **Market shaping.** Although far from certain, one or two large acquisitions could occur and alter the competitive landscape in Brazil. An Indian player might strongly prioritize the Brazilian market and choose to acquire a significant foothold in the market via acquisition.

- **Targeted industry capability.** A more likely scenario is that some suppliers' "tuck-in" acquisitions of targeted industry expertise (products or services) are completed. These acquisitions might also provide a small foothold for a player seeking to enter Brazil but will target acquiring pre-existing expertise that companies can leverage in markets beyond Brazil.

As the global economy continues to work through the turmoil unleashed in 2008, the Brazilian market for outsourcing services should carefully monitor potential changes to competition and industry structure from external competitors. Although many of these external competitors will be occupied with fighting to maintain or rejuvenate their core businesses in other geographies, a few may find the capacity to put significant effort on Brazil and its attractive market.

Summary

The U.S. economic crisis is disrupting spending by corporations. Most companies are currently reducing operating expenses for 2009, which is impacting existing outsourcing agreements. These short-term reductions focus on discretionary spending, often managed by committees rather than individuals. Longer-term, companies will restructure business operations and view outsourcing as solution rather than a cost.

Significant financial challenges are changing the underlying business model of globalization. Offshore suppliers already face margin pressure as industry growth slows. Now large corporations find 20+ percent profit margins unacceptable and demand price reductions. SWITCH suppliers who previously rejected such notions are now sufficiently in need of business that they are making pricing concessions.

Brazilian suppliers can expand the export business by targeting industries where Brazil has unique expertise (e.g., natural resources or petroleum), emphasizing Brazil as a location to diversify the risk of a single offshore location – India. Given that Brazil cannot directly compete with labor rates from India, suppliers' should structure the pricing of proposals in forms other than labor.

The domestic Brazilian market is likely to see increased interest from Indian suppliers that seek additional growth markets. This will occur in the form of increased competition and new value propositions and also may include changes to the industry structure via acquisitions or partnerships.

About the Everest Research Institute

Everest Research Institute (www.everestresearchinstitute.com) serves as a central source of independent and objective strategic intelligence, analysis, and actionable insight for leading corporations, suppliers, technology providers, and investors in the global outsourcing and offshoring marketplace.

The Institute addresses both business process and information technology sourcing topics, providing the global outsourcing and offshoring community with information that empowers highly productive, sustainable sourcing strategies and relationships. The Institute's wealth of knowledge and experience provides unique perspectives into today's marketplace and the competitive edge required to take advantage of emerging opportunities.

Everest Research Institute is the research arm of the Everest Group (www.everestgrp.com), a global consulting firm with offices in such leading business centers as Dallas, New York, Toronto, London, Amsterdam, New Delhi, Melbourne, and Sydney. Everest Group has earned a worldwide reputation for ongoing innovation as it helps clients achieve maximum value from their operations including sourcing strategy and implementation.

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