The Global economic meltdown and its impact on Outsourcing

Analysis of how the current economic downturn will change the market dynamics for the Outsourcing industry

Prepared by Avalon Global Research, India

Market Update 2009

Table of Contents

Executive Summary

Global uncertainties will create volatility and slow the growth of the fast-paced outsourcing sector in 2009. As companies lower their spending on information technology, consolidate operations and exit markets, they will make do with reduced resource levels and be able to find skilled labor locally from layoffs in financial services and other industries. Lack of visibility into the long term impact of this recession will prevent corporations from undertaking larger, more strategic outsourcing initiatives and instead opt for more immediate cost savings through shorter outsourcing contracts with the ability to adjust volume and service level terms dynamically.

Professional expertise and domain knowledge will be valued as companies emphasis larger cost savings, higher performance and lower risks. This will result in reduced top line growth and pressure on profit margins for outsourcing service providers. Analysts predict that service providers will find themselves being squeezed between lower growth, capitalization constraints and demands for higher productivity and cost savings. Outsourcing customers also will rely more on the expertise of outsourcing professionals in their own organizations to help manage the outsourcing process, putting pressure on advisors to demonstrate higher value and be more flexible with their engagement models.

Domestic service providers and near-shore destinations could be the big winners as the outsourcing industry goes through turbulent times in the coming year. Outsourcing will stay closer to home, with available labor from layoffs in many industries and tightened risk profiles of companies. With available manpower and lower wages, competitiveness of domestic and nearshore providers will improve and make them more attractive compared to offshore destinations. Reduced management overheads, travel and communication costs will also add to the growth of nearshore locations. Especially the hard-hit financial services companies will prefer expanding closer to home, as they will be able to justify higher outsourcing levels without increasing the associated delivery and data integrity risks.

Global service providers in India and China will be challenged by the nearshoring trend and will expand their capabilities in this region in order to serve their customers. Providers in these countries also will focus more on their domestic markets and regional opportunities.

Recent election of President Obama will be another factor that will have significant ramifications within the outsourcing sector. The economic stimulus bill is purported to increase government spending in various sectors including infrastructure projects and could lead to more domestic outsourcing, Any restrictive provisions that impact outsourcing of technology or back-office jobs, though unlikely, would be a deterrent to the growth of offshore outsourcing.

Brazil, as a major nearshoring destination, may be in a position to capitalize on some of the emerging changes and new opportunities within the outsourcing space. However to succeed, it will need to align itself to the new dynamics in the market that are changing the way companies source, manage and benefit from outsourcing.

SECTION A

Introduction: State of economic affairs

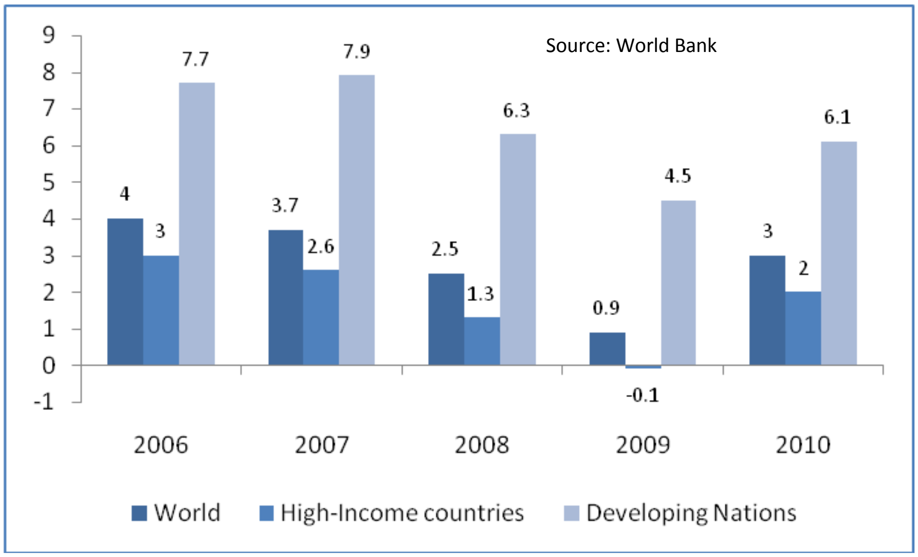
Although the slowdown was originally expected to be confined mainly to the United States, but it has now spread to other industrialized economies and it is not yet clear what the future will bring for emerging markets.

The United States has led the downturn in global sales, with volumes undercut by falling house prices, the ongoing credit crunch and a deteriorating labor market. The US labor market weakened with the unemployment rate rising to 6.7% and employment registering its largest monthly fall since 1974. Manufacturing and services conditions deteriorated to their lowest level since 1982. The US housing market remained under severe pressure with housing sales and prices continuing to fall and housing rate dropped to their lowest ever recorded reading.

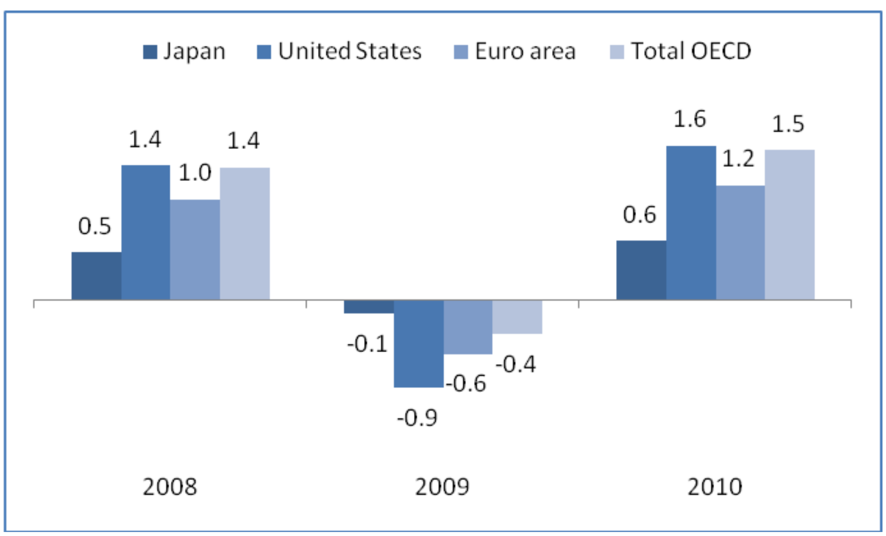
Economic activity in China continued to moderate in the penultimate quarter of ‘08. Manufacturing sector, as did the pace of retail sales growth and fixed asset investment, all seems to be losing the pace of growth in the time of recession. China’s purchasing managers index registered its largest recorded monthly fall due to the continued deceleration in global demand. Economic data from Europe and the UK also remained bleak.

The Macro-Economic snapshot

It is an irrefutable fact that the world economy has seeped into a prolonged slowdown if not an outright recession. The recent report by the World Bank vindicates the same with the growth of world output in 2009 expected to fall to a mere 0.9% as against the 2.5% the year before. Developing Nations too are expected to feel the heat of the global meltdown, with the growth falling to 6.3% in 2009. However, they are still in a better position than the High-Income countries, which will see a negative growth for the first time in many years now.



The recent data released by the OECD as a part of their Economic Outlook for end 2008 too shows that the developing OECD nations will be worst hit in 2009, lead by the US economy at with a negative growth rate of 0.9%.



The Financial catastrophe

The financial market crisis that began in early 2007 is almost unprecedented in its impact, having resulted not only in losses in markets and for financial institutions, but also in an erosion of public confidence and investor sentiments in the financial sector and among the institutions themselves across the industrialized world.

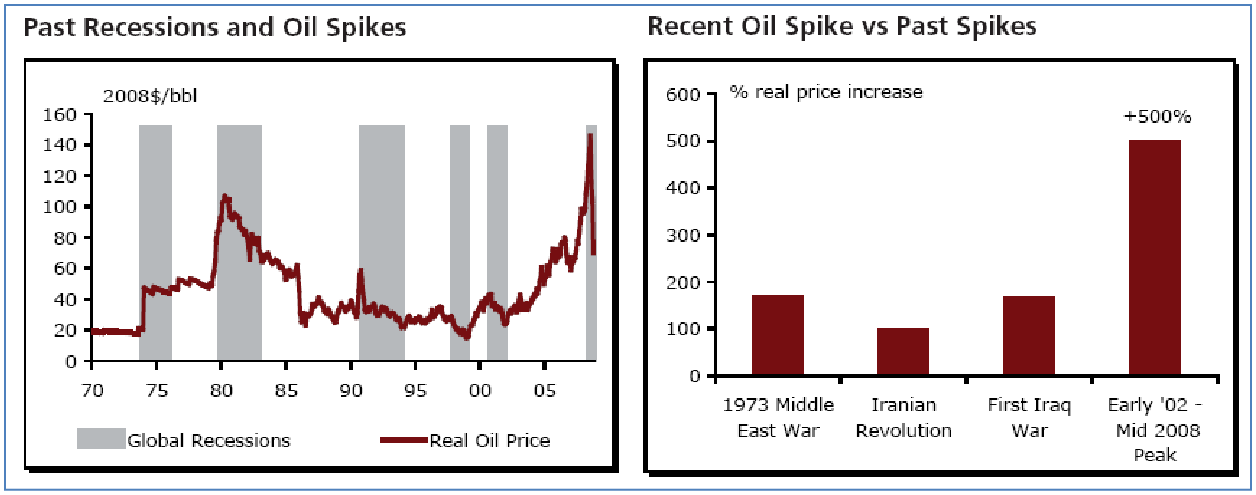
The markets world over have performed remarkably down from the comparable period last year with China and India registered the biggest fall from their respective peaks during July '07- July '08.

S No	Index	One year Max	One Year Low	Change from peak	As on 31st July '08	Change from peak
1	China Shanghai	6,092	2,652	–56%	2,776	–54%
2	Philippines Manila	3,838	2,342	–39%	2,513	–35%
3	India BSE 30	20,873	12,576	–40%	14,356	–31%
4	Taiwan TSEC	9,810	6,711	–32%	7,024	–28%
5	Hong Kong HIS	31,638	20,387	–36%	22,741	–28%
6	Australia All Ord.	6,854	4,910	–28%	5,053	–26%
7	Singapore STI	3,876	2,793	–28%	2,930	–24%
8	Japan Nikkei 225	17,459	11,788	–32%	13,377	–23%
9	Russia RTS	13,337	9,962	–25%	10,369	–22%
10	US Dow Industrial	14,165	10,963	–23%	11,378	–20%
11	UK FTSE 100	6,725	5,151	–23%	5,412	–20%
12	Brazil Bovespa	73,517	48,016	–35%	59,505	–19%
13	US S&P 500	1,565	1,215	–22%	1,268	–19%
14	Indonesia Jakarta	2,830	1,909	–33%	2,305	–19%
15	South Africa JSE	33,233	24,005	–28%	27,720	–17%

- The data is between July '07 – July '08
- Source: EAC India, AGR analysis

Commodity price shock

The simultaneous rise and downfall of energy and commodity prices has had a *'double whammy'* effect on emerging and developing economies causing inflationary swings and also, creating pressure on central banks to maintain liquidity.

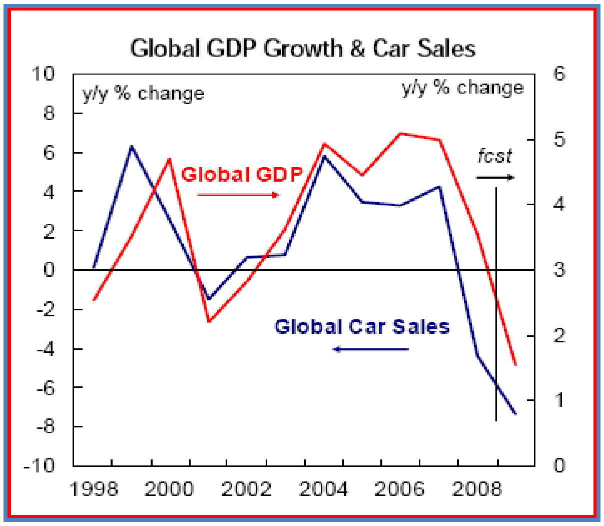


Source: CIBC World market Inc.

Prices in all commodity markets have fallen sharply since July 2008 reflecting slower GDP growth, increased supplies and revised expectations. The sharp slowing of growth that is expected over the next year has caused prices to decline rapidly even though the underlying supply and demand tensions are little changed from just a few months ago when these prices were close all-time highs. The downfall of commodity prices will have impact on the economies of the producer nations.

Plummeting Auto Sales

After several prosperous years, global auto sales have witnessed a severe and precipitous fall-off, as the international financial crisis has led to a synchronized global economic slowdown and nearly a 30% year-over-year slump in car sales in late 2008.



Source: Global Auto Research, Scotia Bank Group

The accelerated pace of monetary easing by central banks around the world since October, as well as stimulus packages being introduced by many governments, should help buoy global economic activity by the second half of 2009, leading to some stabilization in vehicle purchases.

The Policy play

Global economic conditions prompted aggressive rate cuts by central banks worldwide. Global monetary authorities have slashed interest rates by more than 2 percentage points since the advent of the financial crisis — the fastest reduction on record. In fact, benchmark overnight interest rates are now less than the core inflation rate in many countries for the first time since the early 1980s.

Global growth is likely to be very weak out to mid-2009, with developed countries contracting. This should lead to falling inflation and interest rates in most major countries which, along with fiscal stimulus and lower energy prices, will aid recovery in the second half of 2009 and/or through 2010.

SECTION B

Global Outsourcing 2008

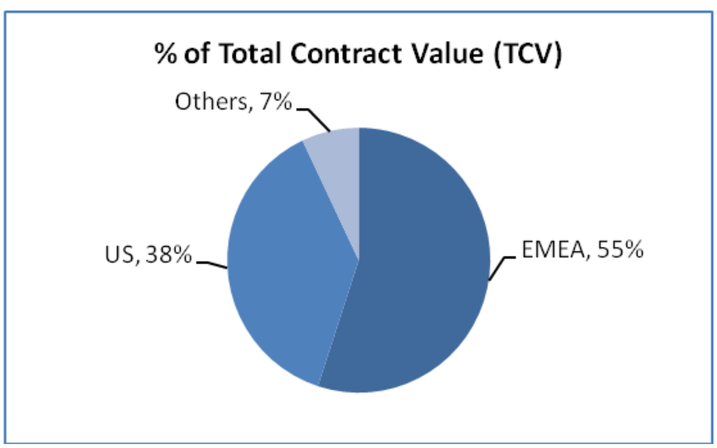
According to a recent TPI[1] report, 2008 was a strong year for the outsourcing industry with both total contract and annualized contract values exceeding overall values for 2007. The Annualized Contract Value (ACV)[2] was the largest ever with a record $17 billion.

However, the global financial crisis will have an impact on the form of outsourcing contracts, as corporations would like to focus on near-term concerns related to their day-to-day business. Non-essential and discretionary projects will probably be delayed or cancelled**.**

The 12 percent increase in smaller contract awards, presents another evidence of a tactical re-orientation of outsourcing. These comprise contracts of less than USD 1 billion in value and represent the inherent demand for outsourcing among mid-size corporations as well as a tendency for larger corporations to use multiple vendors. Thus, smaller duration and smaller value contracts would be the key strategy of the outsourcing companies.

While declining activity in the BFSI has had a deep impact on the overall outsourcing industry, the manufacturing, telecommunication and energy offered some respite by way of moderate or substantial amounts increase in their Total Contract Values (TCV). In the second half of the year, financial services witnessed an increase in their TCV with the divestment of captive offshore operations and subsequent issuance of an associated outsourcing services agreement, by many companies. Also, one bright spot in the economy, the Healthcare sector continues to increase its share of the outsourcing pie.

There has been an increasing adoption of IT outsourcing by EMEA region (62%) in their overall 55% share of the Global Outsourcing TCVs. The Americas had an overall share of 38% of Global Outsourcing TCVs with high adoption of Business Process Outsourcing (43%) in 2008.



[1] TPI is a leading global sourcing advisory firm based out of USA
[2] Total Contract Value divided by the duration of the contract

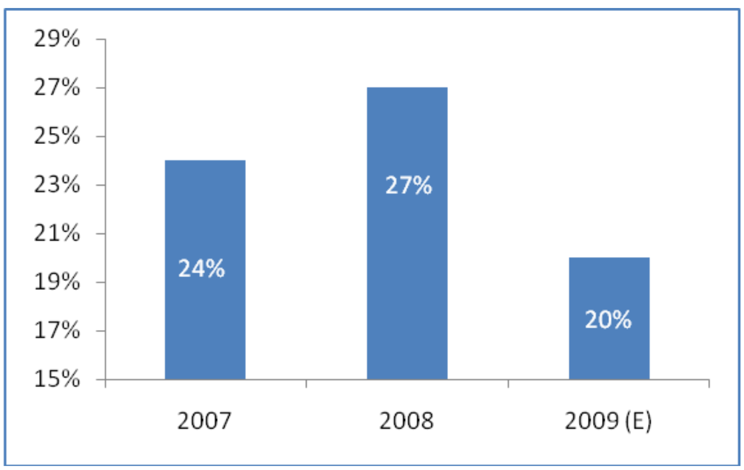
Recession to continue fuelling the Outsourcing trend

Despite the global liquidity crunch, the enterprise use of IT and Offshoring are still the catalysts in driving business efficiency and cost savings. Delivering more for less would be the key ingredient to address the issues faced by the industry, as clients continue to feel the need for more belt tightening measures.

While the global economic crisis continues, the outlook for the outsourcing industry remains positive. The economic downturn will reshape the approach to outsourcing projects. The difficult economic conditions will push companies further than before to consider what stays in-house and what gets done by others. Additionally, demands by the business for further cost reduction will need to be addressed in an environment where many companies have already leveraged labor arbitrage.

Service buyers will need to re-structure their strategies and implement a mix of near shore and offshore models, while service providers will look to tap growing domestic markets (Mainly the BRIC nations and US) at a time when off shoring seems not to be the best option in the outsourcing industry. The Global Offshore Outsourcing industry valued at over USD 50 billion was growing at a 29 percent annual rate until the credit crisis hit last fall. But now the growth in 2009 could be hovering around 18-20 percent.

% Y-o-Y Growth



Going by the past trends, it is estimated that the growth to be range bound at 20% levels during 2009.

Source: Industry Experts, Forrester Research

The outsourcing industry has exploited 'lower costs' proposition to the hilt, but relying on this for future growth could spell disaster. Service providers, both nearshore and offshore have to offer value far beyond lower costs to entice service buyers. The nearshore firms have a distinct advantage of possessing similar time-zone, cultural affinity and similar business environment. Additionally, countries like Brazil have a vibrant Financial Services and Healthcare sector which equips the service providers with domain knowledge in those verticals.

Another factor impacting offshoring is the erosion of confident and higher risk profile created by recent events The recent fraud scandal at the leading Indian IT vendor Satyam sent shock waves not only through the whole outsourcing industry but also was a wake-up call for service buyers.

The recent election of President Obama will likely be another factor that will have long term implications on the global sourcing industry. The new President comes in with a pledge to bring back American jobs from offshore, however he will be cognizant of the importance of outsourcing to the American economy and will probably take a calculated risk when making any amendments impacting the current outsourcing policies. On one hand he has to secure American jobs, on the other hand he has to balance the needs of corporations to become more competitive and global. Barring a radical “no outsourcing of American jobs” bill, the economic downturn is expected to fuel demand for outsourcing in 2009.

The clients for the outsourcing industry would also closely evaluate options of setting up their own captive centers or alternatively also opt for new vendor evaluation techniques. In fact firms who have outsourced for many years and reached a certain level of maturity may consider options of establishing a direct presence or local program management office for better control.

As a result of IT budgets cuts and efforts to bring down the costs, outsourcing companies will be decreasing the use of on-site outsourcing staff - the most expensive IT resource. Outsourcing providers should get the most from their existing workforce and improve talent management practices, as this will increase productivity and employee satisfaction.

With deals getting smaller, and pressure on services firms to cut down on hiring, combined with the need for added global scale, process and technology expertise, are going to drive consolidation amongst service providers at a much more aggressive pace than in 2008.

IT Outsourcing is facing the heat of global meltdown

The US IT market outlook is down but not as bad as the 2001-02 tech depression. On the other hand, the IT consulting and systems integration services will hit the wall in 2009 and IT outsourcing growth will remain moderate in 2009 and 2010. According to Forrester Research's recently revised IT spending forecast for 2009, IT outsourcing services will do a bit better than IT consulting and systems integration services, with the latter vulnerable to the slowdown in purchases of software to be implemented and integrated.

The recession in the US is forecasted to last into mid-2009, with declines in real GDP of as much as 3.6 per cent on a quarterly basis. This kind of decline in the economy will slow growth in business and government purchases of IT goods and services down from 4.1 per cent in 2008 to around 2.0 per cent in 2009. The weakening of the US tech market was already evident in the Q3 2008 data, which showed US revenues of large vendors down by 2 per cent.

According to the forecasts, the recession will not be a replay of the 2001-2002 downturns, when tech vendors saw big drops in revenues. Mainly the computer equipment vendors will see declines of 5-10 per cent in US revenues on a quarterly basis, not the 20-25 per cent drops of the early 2000s. Sellers of communications equipment, software, and IT consulting and outsourcing services will see one or two quarters of declining revenues, but on average will still grow modestly in 2009.

The current market trend shows financial services, consumer durables, construction and housing, retail, and industrial products (including automobiles) to cut back IT purchases in 2008 and 2009. The financial services industry is expected to cut IT purchases by 3-4 per cent in 2008 and 4-5 per cent in 2009, and the construction industry by 2-2.5 per cent in 2008 and 2009[3]. The retail industry will have no growth in IT purchases in 2009, and IT buying by industrial manufacturing will slow to 1 per cent in 2009, and the state and local government IT spending will also be weak.

Global IT outsourcing and consulting services vendors have seen 3 per cent decline in US revenues in the third quarter (ended September) of 2008. Even large Indian vendors, that are good bellwethers for the IT outsourcing sector, saw revenue growth slip to less than 20 per cent, with Tata Consultancy Services (TCS) posting just a 6 per cent increase. Infosys and Accenture had the strongest growth in US IT services revenues at 17 per cent.

Going forward, continued decline in big bang mega deals and increased competitive intensity for renewals will be observed in IT Outsourcing.

[3] Forrester Research Report *'US IT Market Outlook: Q4 2008'*

Auto Sector is among the worst hit

Looming over the bleak economy is the potential collapse of America's Big Three automakers - General Motors, Chrysler and Ford. If any of these companies with transcontinental operations go bust, it can spark a chain reaction, pulling down operations in numerous countries, affecting even successful rivals like Toyota and Honda and leading to millions of jobs losses across borders.

The auto bankruptcies can create a ripple effect across the industry as there are thousands of ancillary companies supplying a steady stream of parts - ranging from light bulbs to transmission systems - to the Big Three automakers in the US. With car sales declining in the US, these suppliers are already in trouble and a bankruptcy at Detroit can send hundreds of them belly-up across countries, and render additional hundreds of thousands of workers jobless. Hence the US government is stepping up efforts to rescue the automobile industry.

The slowdown in the US automobile industry is also likely to impact the growth of IT companies. IT companies could be hit by delayed payments and a freeze in contracts as their major customers in the auto sector face threat of bankruptcy.

The top three US automakers—General Motors (GM), Ford Motor and Chrysler—are seeking a bailout from the US government. And, even if they succeed in getting the bailout, their IT expenditure could drop more than USD 1.5 billion a year, said analysts. Future contracts could come with demands for price cuts, which the IT majors will be pressurized to agree to.

Auto companies would shrink in size to trim their operations. Some of them will shut down a few plants, which will in turn reduce their IT spending. The companies are also likely to axe expenditure on new IT initiatives. The magnitude of the impact would be known in Q1 of 2009, once auto players have a re-look at their IT budgets. In case of a bailout, the US auto companies would cut their discretionary spend to stay afloat. As of now, about a third of their IT spends are of discretionary nature which will get impacted due to the upcoming pressure of scaling down operations. It is also likely that the restructured auto firms will shy away from large multi-year contracts and opt for a multi-vendor option to diversify risk and increase price competition.

Going forward the auto industry is expected to see more consolidation, strategic alliances and restructuring. With the prospect of potential huge mergers and bankruptcies, there will be a natural shrinkage in the value of outsourcing contracts in the future.

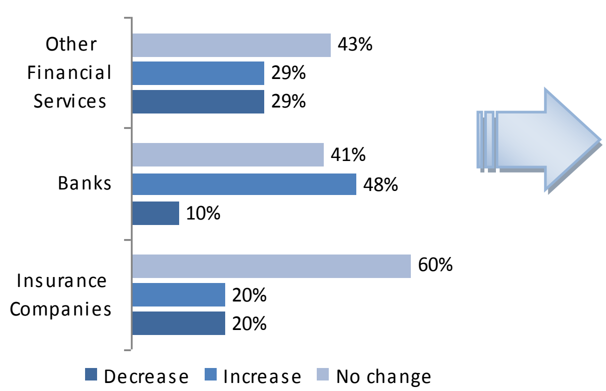
BFSI outsourcing on the decline, though offering significant promise

The unprecedented economic crisis has directly, in fact most adversely, affected the financial sector and indirectly organizations across industries. Recent times have seen a flurry of mergers and acquisitions, takeovers and well publicized bankruptcies.

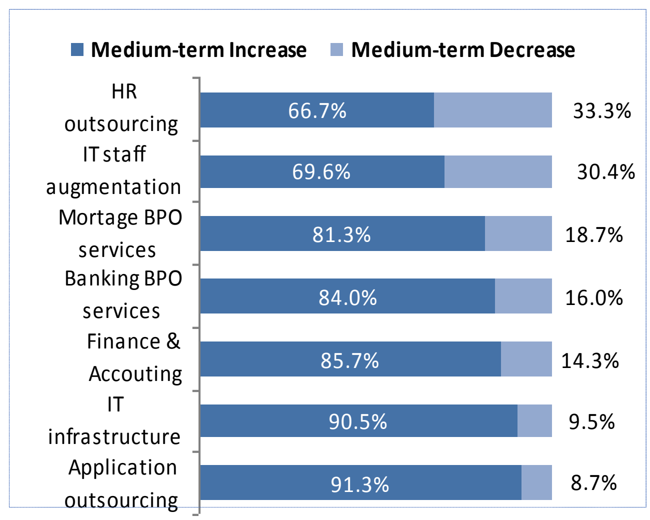
According to a recent Everest publication, despite a 40 percent increase in outsourcing transactions by financial services firms during the third quarter, a slowdown is emerging due to delays in initiatives and managements' keen focus on the economic crisis. However, in the medium-term, restructuring, integration, and redefinition of sourcing strategies by large financial firms will lead to an increase in project-based work for suppliers and increased pressures on captives.

A survey conducted by an independent research firm AMR Research reveals that 48% of the banks[4] surveyed, are willing to increase their expenditure on outsourcing services. Though, the Insurance sector is not too optimistic about outsourcing in the immediate term, firms are expected to adopt insurance-specific BPO services.

Immediate impact on outsourcing expenditure amongst BFSI firms



Banks to focus on BPO and Application outsourcing in these beleaguered times



The current financial crisis has also activated keen interest across stakeholders to understand adoption trends and opportunity areas in offshoring, among other cost containment measures. Business Process Outsourcing is expected to increase significantly, with increased cost pressures and vertical specific offerings by offshore suppliers being the key drivers. The financial services industry, comprised of banking, capital markets and insurance, is the leading adopter of off shoring services and accounts for 40 to 45 percent of worldwide global sourcing.

4 Sample size of the survey = 29 banks

Speaking of vertical specific BPO functions, there exist untapped opportunities in banking arena with specialization in transaction processing, account servicing and credit card fraud management. In the insurance sector, the potential areas include policy servicing, customer service, finance and accounting, new business acquisition and claims processing.

Another trend witnessed in 2008 amongst Financial Services companies, was the divesture of captives and subsequent issuance of an associated outsourcing services agreement. A case in point is Citibank, which recently sold its Indian captive BPO business to Tata Consultancy for USD 512 million in an all cash deal. This would enable it to focus on its core businesses and also help reduce operating expenses related to business processing. Tata Consultancy Services, or TCS, would provide process outsourcing services to Citibank and its affiliates through Citigroup Global Services, or CGSL, over a period of 9.5 years.

Another BFSI behemoth, Fidelity Investments is looking at selling its captive technology solutions unit in India and reward a multi-year outsourcing contract to the new buyer for providing services to Fidelity. Earlier in 2008, UK insurance giant Aviva sold its captive back office operations in India to WNS Holdings and committed $1-billion outsourced work to WNS for eight years.

Industry analysts including Forrester Research are of the opinion that going forward around 60% of the captives in India will adopt some exit modes driven by managing difficulties and sluggish growth. And this is especially true for the financial services vertical.

Increased M&A activity in the financial sector would also mean that merging companies would want to integrate their existing outsourced services – leading to an increase in spending for systems integration projects. The processes will revolve around integration of software applications, data center consolidation and tighter integration of other operational platforms. With financial institutions such as Lloyds TSB/HBOS and Bank of America/Merrill Lynch merging, service providers will also find themselves bidding against incumbent transnational rivals like IBM, Accenture and HP/EDS for large-scale integration contracts.

Global economic downturn will lead to increased outsourcing in Healthcare and LPO domains and alternative Models like SaaS and RIM

The global economic downturn is motivating service providers to focus on recession proof industries like Healthcare and Education. The healthcare industry globally has been a good adopter of global outsourcing in the last couple of years and we observe this trend to continue in the coming years. Mandated digitization of medical records and electronic transactions is driving a major shift towards enterprise level IT in Healthcare firms, necessitating the use of IT outsourcing and Business Process outsourcing firms.

An outsourcing segment that is seeing a positive impact during this economic crisis is the Legal Process Outsourcing (LPO) sector. The crunch in availability of funds with different organizations and groups has compelled the solicitor firms to reduce their costs so as to provide the same services at more competitive prices. Hence, we may find the focus of outsourcing now tilting towards the legal services in place of secretarial and paralegal services. Apart from these, increase in bankruptcies, M&A and litigation due to global financial crisis is generating robust demand for outsourced Legal support services. We expect this to result in strong growth for LPO firms.

Another important trend that is impacting the outsourcing industry is the slow demise of licensed enterprise software and emergence of “pay as you go” models such as SaaS (Software as a Service). Global services vendors are embracing SaaS as a way to de-link from a labor arbitrage based linear growth model. SaaS offers opportunity to earn annuity based revenues along with embedded support and enhancement contracts. Remote Infrastructure Management (RIM) is also gaining traction since corporations want to divest from hard assets and not spend on owning and managing IT infrastructure. Hence services vendors can acquire their client’s IT assets and manage them remotely on a service basis. These so-called alternative delivery models could surge in popularity and pave the way for renewed outsourcing growth once companies are over the economic crisis.

Recession will boost Nearshoring, thus benefiting Brazil

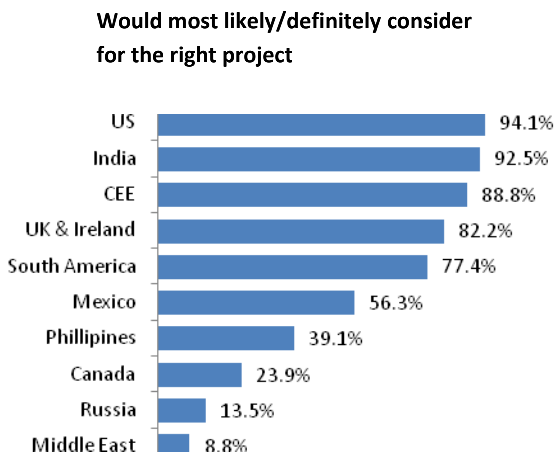
Near shoring as a low cost alternative to domestic sourcing will assume greater importance for processes requiring the same time zone presence. Latin America with superior cost dynamics will emerge as a near time zone alternative to Europe / US businesses requiring Spanish language capability.

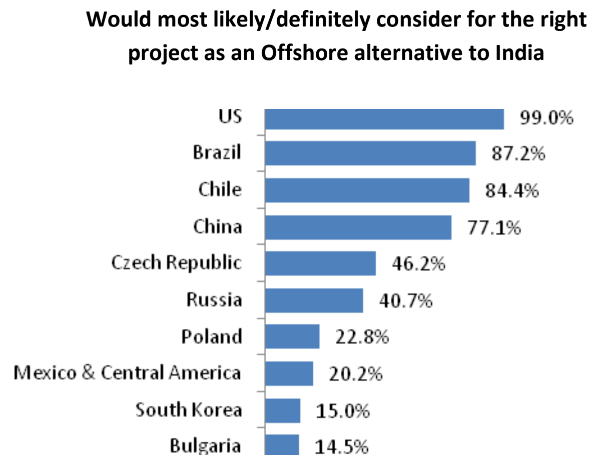
The North American market will need to find a way to reduce costs while achieving desired performance at a lower risk. This will drive the trend to outsource closer to home, and thereby increase the demand for Latin American services. They offer a stable rate against the dollar, as well as close proximity, and a familiarity with US business processes. Moreover, the rising US Hispanic population is driving the demand for Spanish language support services, which are best provided from Latin America. Another indicator of the nearshoring trend is that most top Indian vendors are expanding their global footprints and opening delivery centers in Latin America to provide nearshore options to their clients.

Brazil is the leader in outsourcing in the Latin American region. Brazil enjoys numerous key benefits, from a sophisticated technological infrastructure, a strong and young employee base, proximity to the U.S., and a host of seasoned solutions providers skilled in the global sourcing market.

Even though not as cost-competitive as other destinations, Brazil enjoys the advantage of good education system, highly skilled talent base and a scalable work force. Hence, though the relatively higher wages might discourage low end outsourcing work, it is well suited for higher end services such as ERP systems support, Managed services, Knowledge Process Outsourcing and BPO services catering to the Financial services, Healthcare, Manufacturing and Telecom sectors.

According to Brown and Wilson Group's survey conducted in 2008, India remains the most preferred outsourcing location, based on current and past experience, for 73.5% of respondents. However Brazil emerges as a strong potential alternative to India, with 87% saying they would consider outsourcing to Brazil for the right project.





Source: Brown and Wilson Group, 2008

Brazil can benefit from this affinity by positioning itself as a strong alternative to India and take a competitive lead by establishing competencies in Healthcare, LPO, SaaS and RIM delivery models. Moreover its existing providers with strong ERP and Financial services capabilities can easily adapt and offer these value-added services to US clients.

Brazil is one of the few Latin American countries with the size and scope to handle the current pace of outsourcing growth, it is also far ahead with the right level of IT sophistication and preparedness for the U.S. markets

Brazilian IT and BPO services firms have a unique opportunity to capitalize on this trend by emphasizing their capabilities and nearshore advantages. US firms will outsource closer to home, demand immediate savings, pressure service providers, value professional certification and domain expertise, and emphasize social responsibility in 2009. They will also diversify risk and look for multiple service providers. By gearing their value proposition to serve these needs, Brazilian firms would be well positioned to leverage the impending shift from blanket off shoring to a blend of nearshore-offshore. This "right shoring" trend could see Brazil emerging as a major outsourcing destination in the post economic crisis era.