

THE NO MAN'S LAND OF MIDDLE MARKET OUTSOURCING: HOW FIRMS WITH UNDER \$2B IN ANNUAL REVENUE CAN GET THE SAME ADVANTAGES AS LARGE FIRMS

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The increasing maturity of IT outsourcing over the last decade has made it one of the most impactful workforce and business innovations the technology industry has seen in a long time. End-user organizations have been able to leverage and scale additional and specialized IT expertise, make certain costs variable and reduce others, integrate additional process, technology, and industry knowledge into their teams, and respond to customer demands more quickly. These advantages have allowed large organizations to provide better value to their customers while simultaneously reducing their costs.

The problem has been that end-user organizations with fewer than 100 FTEs' worth of long-term IT work to outsource, whether companies or autonomous divisions of larger organizations, have struggled to enjoy these advantages. Typically, these divisions or companies are either non-technology companies with under \$2 billion in annual revenue or are smaller technology-focused firms. The problem lies in the structure necessary to take advantage of global outsourcing. At this stage in the maturity of the global delivery model, the structure necessary to take advantage of a global delivery team is clear. There must be:

- Outsourcing company staff with deep knowledge of the outsourcing company's delivery team based on-site at the end-user organization
- Additional end-user organization staff dedicated to managing the relationship
- Several layers of management in each of the outsourced delivery locations dedicated to communication with the U.S.-based leadership and management
- Redundancy in outsourcing company staff and in end-user staff, on-site outsourcing staff, and delivery location staff
- Frequent and continual travel by the two groups of outsourcing organization managers and the internal managers of the end-user organization responsible for the outsourcing relationship to ensure a deep enough level of knowledge and trust of the teams' ability to be able to communicate and distribute work effectively

- Clear and detailed requirements definition as well as a defined change request process
- Compatible development and project management methodologies in place within the end-user organization and outsourcing company

For a large team with a long-term relationship, these necessary steps are onerous but still worth the effort given the various benefits of global outsourcing. Furthermore, assuming the economies of scale inherent in large outsourcing relationships, the costs associated with them are historically less than the savings offered: many extremely large relationships (i.e. between 1,000 and 5,000 FTEs) suggest that the net savings are still 20% or so off of a typical domestic outsourcing relationship.¹

THE MIDDLE MARKET CHALLENGE

The problem, of course, is that for an organization in need of less than 100 FTE's worth of sustained effort, the anticipated financial savings do not materialize.

Middle market consumers of IT services face a Hobson's choice when attempting a global delivery solution. Either the end-user organization puts the necessary structure in place, in which case the costs for global outsourcing are meaningfully higher than using internal staff or outsourcing in a standard domestic fashion. Or the end-user organization does not use all of these well-established strategies, with a result of lower-quality output and more hours to complete the same tasks.

Many middle market firms and smaller divisions face an additional challenge making a global outsourcing model work effectively. Since process is critical to make global outsourcing effective but real-time communication between end-users and technical teams is often not possible, cultural, language and time zone differences can become real issues in what should be tightly knit project teams. These issues are compounded by not having regular face-to-face contact with the outsourcer. As a result, clear requirements become that much more important, and the negative effects of ambiguity in those requirements are that much more significant. Multiple, disparate constituencies inside of an end-user organization that need to communicate independently from one another with the outsourcing company to resolve differences can make effective results almost impossible to deliver in a global delivery model. These kinds of challenges are most acute in rapidly growing and changing organizations.

¹ Moreover, recent developments in currency fluctuations and wage inflation will inevitably lead to a deterioration in the historic 20% savings. The rupee on January 1, 2007 traded at 44.11 rupee to the dollar; on January 1, 2008 one dollar was worth only 39.41 rupees, a decline of almost 11%. Wage inflation at roughly 15% or higher annually in India further reduces the savings.

Middle market end-user organizations turning to standard domestic solutions fare no better. Typically, such domestic outsourcing providers are unable to engage effectively in a smaller relationship, and if they do there is less flexibility and lower-quality staff working on those engagements. And of course, their costs are often at a significant premium even over building internal capacity in these areas.

Resorting to the traditional model of internal hiring might seem a better alternative. But this means forsaking the potential benefits of using an outsourcing company, including no cross-pollinating expertise working with multiple companies, technologies and processes, no cost savings and no costs variability.

THE REMAINING ALTERNATIVE

The remaining alternative, which is rapidly becoming a preferred model of engagement in these situations, is so-called “onshore” outsourcing. The options are either sourcing from a lower-cost geography in the United States or working with an outsourcing partner that leverages more effective talent sourcing solutions to increase efficiencies that can translate into economics passed along to a customer. Lower-cost domestic geography outsourcing has become a very popular option for a range of firms. These companies will identify a lower-cost location, such as in the Plains States, southwest Virginia, or South Carolina, and build a development center in that location. Rent is lower, and because there is less competition for talent, wages tend to be lower as well. Furthermore, at times local and state government incentives can further improve the economics of such a strategy.

The challenges occasionally faced in lower-cost geography onshore outsourcing include being able to find talent rapidly in a new location, accessibility to delivery locations, and ensuring sufficient savings to justify the effort, but all of these challenges are increasingly manageable. Applying improved talent acquisition techniques can address the first and third issues, and the second is minor compared with the challenges of a global strategy.

The other onshore outsourcing option is to work with an outsourcing partner with a more-effective talent sourcing solution that creates cost savings. This strategy may be as simple as using technology more effectively to reduce recruiting costs, which can be a significant cost for an outsourcing firm, or as sophisticated as using more-innovative talent acquisition solutions to increase hiring speed, increase talent funnels, and reduce turnover. For an outsourcing firm, the product is expertise, and as a result turnover, delayed hiring, wage inflation, and recruiting costs are four of the largest manageable expenses and three areas where different strategies can generate savings that reduce costs for customers and increase margins for outsourcing firms.

Firms offering this category of onshoring do not need to be located in remote areas. They likely have top-flight talent quality and reduced turnover, and can often be located locally or on-site to a client. As a result, they are able to address many of the challenges of global outsourcing strategies for firms in this size, while avoiding many of the challenges of other domestic onshoring models.

SUMMARY

Outsourcing gives major advantages against their competitors for those able to utilize it:

- *Leveraging expertise in industries, technologies, and processes not otherwise available internally*
- *Ability to scale more quickly to customer demands*
- *Making costs variable*
- *Reducing overall costs*

However, to make an outsourcing relationship work effectively, certain infrastructure and costs are necessary that make engagements smaller than 100 FTEs or shorter term less effective:

- *Multiple outsourcing company staff on-site at end-user*
- *Multiple end-user internal staff dedicated solely to managing relationship*
- *Multiple outsourcing management layers at each delivery location*
- *Frequent and ongoing travel*
- *Staff redundancy to address turnover*

These requirements make middle market outsourcing relationships more challenging:

- *Infrastructure makes total costs higher than domestic options*
- *Alternatively, lack of infrastructure results in lower quality, longer delivery times, and delivery inconsistent with requirements*
- *Ambiguity in requirements is more problematic because of less real-time and face-to-face communication*

Alternatives are internal hiring, typical domestic outsourcing partner, or “on-shore” outsourcing:

- *Internal hiring sacrifices outsourcing benefits enjoyed by larger competitors*

- *Typical domestic outsourcing options are expensive, unavailable for smaller engagements, lower quality, or less flexible*
- *On-shore outsourcing to lower cost geographies can frequently have benefits, but certain infrastructure is still required, and they may have lower or inconsistent quality and limited cost savings*
- *On-shore outsourcing to firms with more effective talent sourcing solutions deals with the challenge of global strategies for firms in the under \$2 billion revenue range, without some of the limitations of the lower-cost geography onshoring model*

Catalyst IT Services is a leading provider of on-shore application services outsourcing solutions. Serving Fortune 500 and middle market clients out of development center in the United States, Catalyst serves the onshoring needs of the most prominent enterprises in the financial services, healthcare, telecommunications and technology, outsourcing, and retail industries.