

## Global Sourcing Drives Cost Savings In Tough Economy

Over the course of the last 18 months, the industrialized world entered a deep recession. Rapid increases in the price of oil and related consumer goods, and a nearly simultaneous collapse in the value of residential real estate demolished consumer and investor confidence worldwide. These forces drove an unprecedented liquidity squeeze compelling governments across most of the industrialized world to commit trillions of dollars in economic stimulus. In the resulting aftermath, consumer credit plunged by \$7.3 billion in February. GDP for the most recent quarter is 6% below the same period of a year ago. February industrial production is down 11.8%, consumer prices are up 4%, and unemployment hit a relative high of 8.5%. American business hasn't been this focused on cost reduction and efficiency since Christmas of 1929.

### Cutting Costs is a Key Strategy

CEOs across a variety of industries are turning over every rock looking for cost savings. Obviously, cost reductions are the most immediate lever available for attenuating the business in uncertain times. In the middle market (companies with revenues of \$25 million to \$1 billion) where there is even less margin for error, cost cutting is the crucial survival tool. A study released by Forbes during 1Q09 surveyed 150 key decision makers in the middle market. In this study, 73% of respondents indicated that their organization would support and achieve growth by focusing on operating efficiencies and over half, some 53%, expected more cut backs in staffing. If the axe isn't already swinging, the CFO is in the tool shed sharpening it.

### Globalization in the Middle Market: Untapped Cost Advantages

Unlike most global 1000 companies where the use of a global sourcing model for talent has driven extraordinary reductions in labor cost across information technology, human resources, finance, accounting, and customer service, middle market companies have been slower to take advantage of globalization. According to Everest Research Institute, "offshoring in the middle market is quite low [as] large company contracts include an offshore component in 68% of deals, while only 23% of middle market deals include offshoring." With the recent effects of a contracting economy and increased focus on cost efficiency, prudent management teams in the middle market will be driven to look at offshore, nearshore, and rural sourcing options to cut expenses.

### Globalization Trends

The macro economic environment combined with increased demand from middle market companies seeking to take advantage of the opportunities that global sourcing provides, will drive several trends worth noting:

- **Cost Arbitrage.** For the near term, the cost arbitrage opportunity remains strong. Rising wages and increased competition for talent in India has driven increased upward pressure on labor. However, the performance demands of publicly traded providers will create meaningful cost savings opportunities for deals completed in close proximity to quarter's end.
- **Skills Arbitrage.** Organizations that take advantage of global sourcing will find an increasing ability to get superior skills as the best talent is more likely to be found in a specialist outsourcing platform than among the ranks of the current internal staff.
- **Increasing Geographic Diversity.** Recent political conflict with Pakistan in India (as well as disconcerting terrorist attacks) combined with rapid increases in competition from other

offshore players (China, Vietnam, Eastern Europe), nearshore players (Brazil, Argentina) and domestic rural sourcing will provoke buyers to diversify risk while driving more competition.

- **Increased Middle Market Consumption.** More middle market companies are expected to take advantage of globalization as providers across the industry have used a variety of innovations to more “right-size” the globalization process. This wider set of alternatives should provide the basis for more solutions, higher demand, and therefore more competition.
- **Emerging Role of Prime Contractor.** As middle market adoption increases, so will the role of the “prime contractor”. Buyers recognize that outsourcing everything to a single entity will not necessarily result in the right combination of cost and quality. The use of multisourcing (obtaining functional and technical capabilities from a variety of sources including offshore, nearshore, and rural sourced) will increase the importance of the primary contractor. Primary contractors provide a single face to the buyer, while offering a variety of globally sourced alternatives.
- **Transaction vs. Labor Based Pricing.** As organizations demand more flexibility from their globalization partners, pricing of deals will continue to transition from a model of cost of labor plus mark up, to one that is driven by activity volume and/or price per transaction. The ability to convert fixed costs into variable costs will increase in importance.

### ***Keys to Successful Globalization***

Successfully decreasing cost while maintaining or improving quality through workforce globalization is a complex topic. The information technology industry has spent the last 15 years focused on creating and evolving process and contract models to align interests between buyer and vendor, while allowing for flexibility and innovation. With the increased focus on cost reduction from first time buyers of global labor services, Gartner estimates that over 50% of outsourcing deals will be renegotiated preterm (and usually shortly after the end of the first year). Gartner argues this will be driven by a focus on tactical outsourcing versus strategic global sourcing. Obviously in a difficult economy narrow margin, cost focused deals are available. But sometimes the cheapest price in the tightest long term contract is bad for both vendor and client. The objective should be a mutually beneficial, long term relationship that brings down cost while improving (or at least not harming) quality. As middle market companies enter the fray, buyers can avoid costly mistakes by learning from the past. Prime contractors can assist middle market companies in avoiding mistakes and structuring an agreement that saves money while building a long term relationship with key suppliers.