Getting attention … The Mid-Market segment is finally coming of age. It is evident from the fact that just a few years ago, it was difficult for smaller buyers to get a large provider to even respond to an RFI, let alone an RFP.

BY **ANUPAM GOVIL** AND **REJO SAM**

The long and short of it: Mid-market Outsourcing

A LOT HAS been talked and written about large, multi-billion dollar outsourcing deals by Global 1000 firms that have outsourced processes like HR, F&A, Procurement and IT to equally large multi-functional, multi-location service providers. However, if you thought that the outsourcing phenomenon and its advantages or disadvantages were limited to large corporations; it is time to think again. These mega-deals in fact have inherently laid the foundations for a far more significant market that encompasses and impacts a much greater number of enterprises and people.

The Economist quoting the latest US Census puts this segment to be responsible for US$6 trillion in sales and for the employment of over 32 million people in the US. More importantly this segment comprises of not a couple of hundred companies but a staggering 106,000 firms. The scale and scope is pretty much similar for the UK and the EU region. As mega-deals now tend to become fewer and smaller, this emerging market is beginning to catch attention and gain recognition within the outsourcing sector. We are talking about the mid-market segment or companies with revenues between US$25 million and US$1 billion.

Although mid-size firms have been tactically outsourcing for more than a decade, since 2005, they have been more openly embracing the concept of function specific strategic outsourcing. The major drivers are to not only be cost effective but also to improve adaptability to rapidly evolving market realities and increase operational efficiencies.

That this segment is finally coming of age is evident from the fact that just a few years ago, it was difficult for smaller buyers to get a large provider to even respond to an RFI, let alone an RFP. However, as the mid-market gains momentum, the number of vendors serving it is growing and even outsourcing giants like IBM Global Services, Accenture, Hewitt and CSC have started targeting them with service offerings distinct from their approach to larger contracts.

So what are the opportunities and challenges faced by the service providers and the potential outsourcers within the mid-market – and is this really a sustainable, viable opportunity?

Smaller size, bigger gains

To start with, mid-size firms are actually faring much better in these recessionary times. A recent Economist survey on the US mid-market segment gives a thumbs-up for growth with over 60% of the respondents sharing positive sentiments for the next year. This market confidence is a sign of higher insulation to the impending recession in the US economy and underlines the different dynamics amongst mid-size firms.

While the mid-market growth story seems to be fine, the issues facing them are similar to those faced by larger corporations some years back – that of global competition and margin erosion. The need to stay ahead of peers while curtailing or variabilizing cost structures is making them look at outsourcing as a viable, long-term and sustainable model. Top issues for these firms are maintaining focus on core competency and adapting to the fast changing market reality. Also with rapid globalization of markets, it has become important to look beyond the borders and go after international markets.

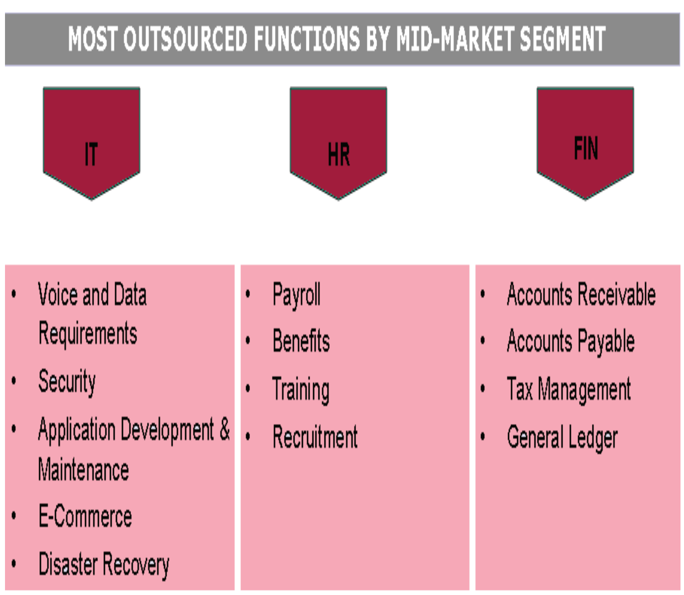
While the reasons to outsource for mid-size firms may sound similar to that of larger organisations the impact is far greater. The segment faces unique challenges both within the organisation and outside. Typically the scale of outsourced functions is smaller for these firms so they inevitably look towards outsourcing higher-value processes, which will impart higher cost savings but also carry greater risk.

This combined with their relative lack of maturity in outsourcing (even domestically), makes for innovative business and outsourcing engagements models. Providers have adapted by offering bundled services that defray the risk as well as have a strong advisory component.

Service providers – a big wide market

As both the number and size of multi-billion outsourcing deals come down, major service providers are increasingly targeting the mid-market segment. Currently, this segment is dominated by mid-size providers with services tailored towards their unique requirements. Most of these companies look at servicing deals with value ranging from US$2 million to US$50 million or involving 50 to 1,000 people. This segmentation has kept them away from the fierce high stakes game of the larger service providers in the larger deals and at same time allowed them to carve a niche in the market.

One of the biggest misperceptions has been regarding the relative size of this segment. Everest predicts that the mid-market will eventually generate US$120 to US$145 billion in total contract value, which is comparable to far fewer large-scale HRO deals, expected to reach US$125 to US$150 billion.



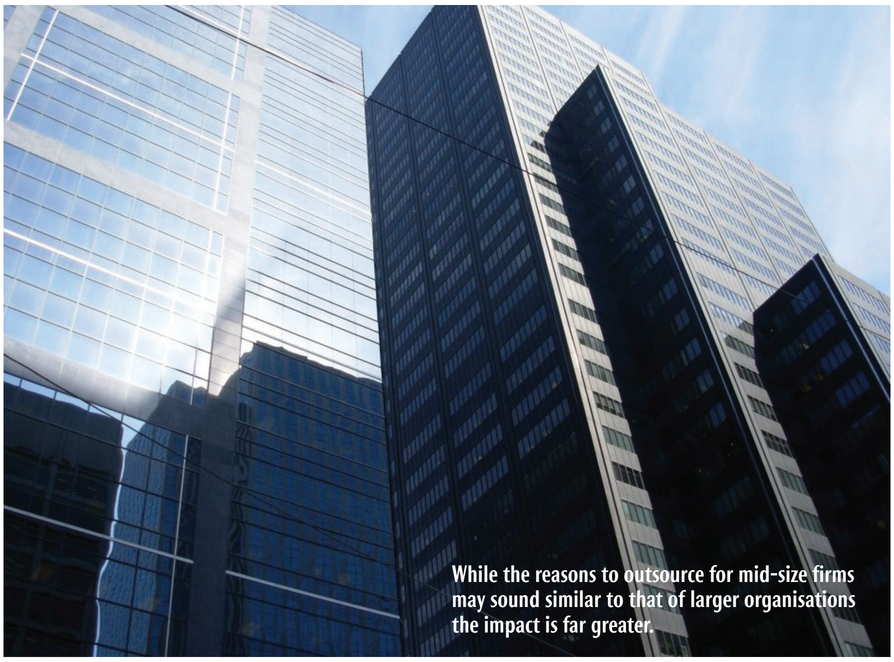
Global Equations – Most Outsourced Functions Ranked in Order of Priority

This is akin to the Long Tail of an asymptotic deal value curve where the combined value of mid and small sized deals almost equals that of the fewer but larger size deals. (See graph 2)

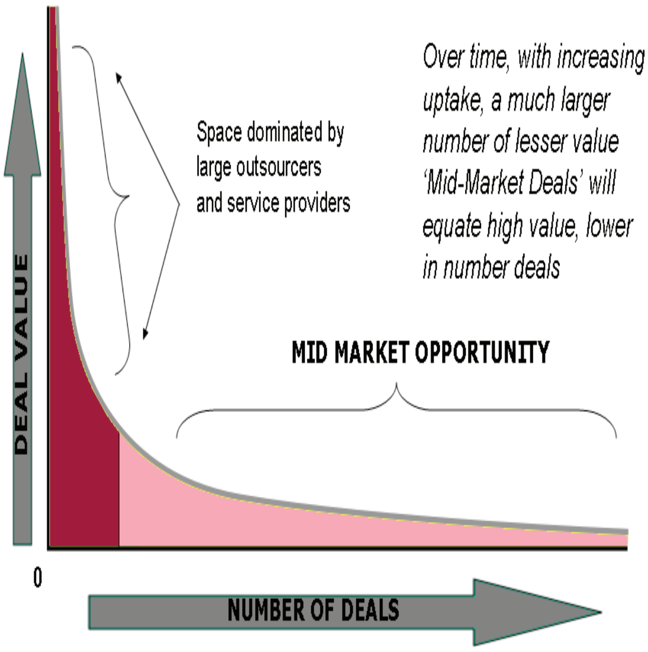
Another reason mid-market buyers are attracting greater attention is the high cost of acquiring major accounts. By several estimates, in a large (US$200 to US$500 million) enterprise deal a vendor may spend US$2 to $10 million and up to 18 months of effort to win the contract. Mid-market clients, on the other hand, cost vendors a fraction to pursue, and they are usually secured in only a few months. Furthermore, large deals don't necessarily mean larger profit margins and many of them have been rolled back by vendors as they turned out to be unprofitable.

In fact, enterprise deals signed in 2005 and 2006 showed that mid-market buyers for HRO pay significantly higher prices per employee than their large-cap counterparts. Additionally, mid-market providers can truly leverage the one-to-many (modularization and bundling) instead of the one-to-one model that large buyers require and hence earn higher margins even at lower volumes. It's clear why the allure of this segment is growing.

Considering the increasing importance of the segment larger service providers have made been making strategic moves into this space. While some companies have built mid-market dedicated teams others have forged alliances or have acquired smaller companies adept at servicing this segment. This is also a clear indication that needs of this segment are distinct and uniquely different from those of larger firms. Since 2005, deals like Accenture's acquisition of Savsita, ACS acquisition of Intellinex are all aimed at targeting the mid-market.



While the reasons to outsource for mid-size firms may sound similar to that of larger organisations the impact is far greater.



Global Equations – The Long and Short of Mid Market Outsourcing

Mid-market challenges

But before you jump to the conclusion that the mid-market will soon become the new darling of the industry, keep this in mind that these deals presently account for only a small fraction of the overall market value. According to Everest, in 2006 mid-market deals only accounted for 12% of total revenue even though it accounted for almost 50% of the number of executed deals. Revenue contributions aside, the mid-market presents some significant challenges to providers of all sizes, so tapping this segment is no cakewalk.

To begin with, there is no broad consensus on even who mid-market buyers are. Whether it is classifying the mid-market by revenue, outsourcing deal size or number of employees, there is such a large disparity, it's no wonder the segment remains nebulous.

Service providers, especially the larger ones need to be careful while servicing the needs of this segment, which are quite very different. Companies in this segment tend to take a much larger financial risk while undertaking an outsourcing initiative and may not even have the wherewithal to emerge from a improperly planned deal. Hence it imperative for service providers or advisors to hand hold clients across the entire transitioning process.

Unique needs

When making an outsourcing decision mid-size firms consider the same parameters as larger firms but provide weightage to different drivers. For example one of the major reasons for back-office outsourcing is to leverage the provider's technology and process expertise. Global 1000 businesses rely on inhouse ERP systems while the mid-market is more closely aligned to application service providers (ASP) or the vendor's preferred platform. Whereas larger firms tend to focus on service levels and delivery, midsized companies value flexibility.

Also important for mid-size firms are various facets like improving turn around time or time to market, ability to deal with multi-vendor scenarios and providing advisory services bundled with the overall solutions. Of course, mid-size firms expect to be treated with same respect as their larger cousins and not offered cookie-cutter solutions – providers that succeed show the ability to strike a balance between providing a tailored solution while keeping costs lower.

Overall a very exciting phase for the whole mid-market segment has already begun. This segment is poised for robust growth with both outsourcers and service providers realigning themselves to adapt to new business realties. As the awareness within mid-market grows, more and more of these enterprises will use outsourcing as a way to globalise and compete with larger more resourceful competitors as well as smaller but nimbler contenders. Equally interesting to watch would be the emergence of service providers with integrated and innovative solutions that are able to ride the Long Tail to success. O

Anupam Govil is an outsourcing and strategy consultant with over 18 years of experience in the technology and services industry. His firm, Austin, US-based Global Equations was ranked in the Top 5 Boutique Advisory firms in the Black Book of Outsourcing 2007. Rejo Sam is a Principal Advisor with Global Equations and heads up their India team for Offshore Advisory and Research.