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STRADLING THE DIVIDE – CAN MID-SIZED FIRMS REALIZE HIGHER ROI THROUGH GLOBAL SOURCING?

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OVERVIEW

Tremendous opportunity exists today for midsize companies to expand, innovate and assume a leadership role in the global economy. As midsize companies globalize and gain access to new cost-effective technologies and capabilities, competitive advantage is based increasingly on innovation, speed to market and knowledge rather than size and scale. Realizing this, midsize companies across the globe are seeking to adapt their business models to market shifts and customer needs by leveraging the power of global sourcing. Faced with a myriad of alternatives, are there specific strategic initiatives they can adopt to remain ahead of their competition? Can they simultaneously expand their market while enhancing their capabilities to take on these new opportunities offered by globalization? How can mid-sized firms effectively harness a global sourcing model to stay ahead of the competition?

While global sourcing brings with it opportunities like never before, it is also a path that has to be tread cautiously as mistakes can have a much more devastating impact on mid-sized firms than larger Fortune 500 companies. This white paper co-authored by Global Equations, a top ranked sourcing advisory firm and Matryzel Consulting, well known mid-market globalization specialists, discusses not only the opportunities and benefits of adopting a global sourcing strategy, but also enumerates the accompanying challenges. This white paper can very well serve as the first point of referral for mid-market companies while embarking on their globalization / outsourcing initiatives.

FACETS OF THE MID-MARKET SECTOR

As the global economy sputters along, the one bright spot seems to be the performance of mid-size firms. Various reports show that the mid-market sector (defined as companies with revenues between \$25M and \$1 Bn) is actually faring much better in these recessionary times. The 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 lurking 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 their larger counterparts at the start of this decade – that of global competition, commoditization and margin erosion. 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 explore international markets. These drivers, along with the need to stay ahead of peers, is making them consider outsourcing as a viable and sustainable model for curtailing costs while leveraging innovative business practices.

Midsized companies today have a myriad of new, cost-effective business and technological capabilities available to them. Competitive advantage is based increasingly on innovation, speed to market and knowledge, rather than size and scale. Realizing this, midsized firms across the globe are seeking to adapt their business models to market shifts and customer needs. These companies also intend to integrate technology both to run their businesses more efficiently and also to enable their businesses to react faster to market realities and opportunities. So what are the strategic initiatives that they can adopt to remain ahead of their competition, while enhancing their capabilities to take on the opportunities offered by globalization?

A recent survey of leaders spanning three continents revealed a surprising consistency in what mid-market CEOs view their challenges to be – Growth, Profitability and Competitive pressures. In the context of growth, organic strategies are seemingly no longer able to provide organizations with the lever required to stay ahead of competition [before commoditization catches up]. This in turn impacts expansion initiatives and hence profitability. Consequently, soliciting private capital to fund such initiatives and sustain commoditization pressures has been on the rise. This infusion of private capital is bringing renewed focus on better capital efficiencies and restructuring of organizations around core versus context functions.

One of the biggest challenges that mid-market organizations are facing (as recently revealed in a study of this sector by IBM) is the increasing level of sophistication from their customers, thereby requiring organizations to look at innovative ways to enhance customer experience and expand into new product/service areas. Adding to the pressure is the need to enhance operational efficiencies (See Figure 1 below).

Focus on operational efficiencies has now transformed itself from being a divisional/ departmental issue to a corporate issue. This is leading boards to explore new ways of bringing in outside advice and resources to streamline and re-engineer business processes – something that was hitherto the domain of larger Fortune 500 firms. Also, market pressure from global firms – both large and small – are resulting in a drive to leverage external partners and vendors to support expansion ventures aimed at creating new lines of business. This, in turn, is now pushing mid-size organizations to review their traditional business models and consider more strategic outsourcing initiatives that have an impact both at the business (top line) and operational (bottom line) levels.



Figure 1: Strategic Focus of Mid-Market Sector CEOs

OPPORTUNITIES TO LEVERAGE GLOBAL SOURCING

Responding to the challenges and opportunities of the global marketplace is as much about new business models and growth strategies as it is about operational efficiencies. At a fundamental level, growth, innovation and serving customers better all come down to core operations. Non-traditional competition coupled with global market forces is pushing mid-size organizations to centralize their common services and build strategic partnerships. From internal services like accounting, procurement and human resources (HR) to customer support and logistics, these centralized services are becoming prime candidates for outsourcing.

Today thousands of small and medium enterprises are waking up to the reality of the outsourcing wave, a market opportunity explored by their larger competitors thus far. "SMEs in the US are under severe pressure to increase profitability and business margins. This will force them to outsource and even have innovative business arrangements with their outsourcing partners. India is going to be a great beneficiary of this trend." said Adam Larkey, partner at Wolet Capital Corporation, a New York-based investment banking firm. The demand spur has begun to take shape especially in the past two years, and the trend is sure to continue given the slump in the US economy and associated issues resulting from the credit crunch. This will only push smaller and mid-sized firms to act more aggressively, making them ready and willing to embrace the global sourcing model. Over the next three years this trend will accelerate as evidenced in Figure 2 below.

According to an IBM study on the mid-market sector, the offshore outsourcing market for US firms is expected to reach \$54 billion by 2010. Of this, the share for mid-size companies that outsource offshore will continue to grow (albeit modestly) and reach \$11 Billion (see Figure 2 below). Reinforcing this trend is the fact that the mid-market sector today accounts for 80% of the US industry in terms of volume, with over 20,000 small and medium firms in the revenue bracket of \$2 million to \$500 million and another 6,000 companies in the \$500 million to \$2 billion bracket. These organizations are expected to drive the adoption of global sourcing models, concurrently learning from the mistakes and experiences of the larger firms, thereby bringing in additional business and financial model ingenuity.

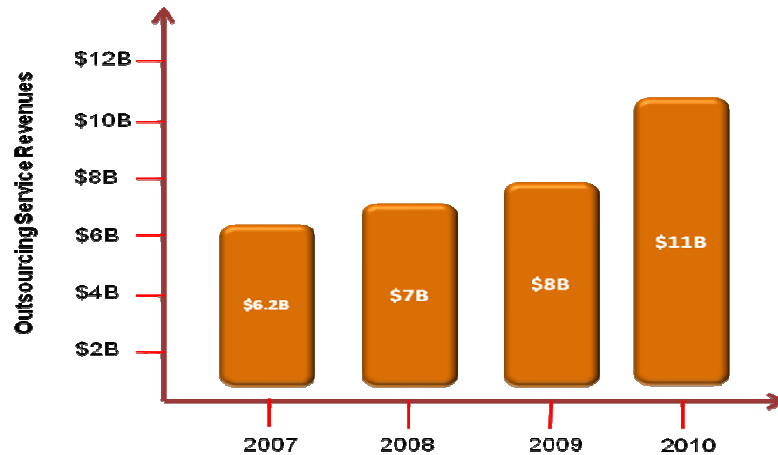


Figure II: Outsourcing Revenue Growth Projections [Mid-Market Sector]

As revealed from IBM's 2007 study, for mid-size banks, more than 76% of executives agree that IT infrastructure security and reliability are keys to protecting financial transactions and customer data. But less than 30% are confident that their current capabilities in this area are adequate. At the same time, less than 30% are building the appropriate capabilities. A similar trend in IT infrastructure management can be seen in the Retail and Healthcare sectors where the security of customer information and identity is paramount. Mid-sized Manufacturers and Wholesalers are facing challenges in scaling and globalizing their operations because of gaps and inadequacies in supply chain management. Critically dependent on the streamlined and accurate flow of goods, parts and merchandise, 78% of Wholesale industry executives agree that supply chain management capabilities are one of their top imperatives. Even so, only 16% are confident that their current capabilities are complete. And only 22% are currently building effective IT capabilities for their supply chains. Given these inherent challenges, many of the same executives concur that leveraging the IT and operational competencies of third party service providers is the most effective way of surpassing these bottlenecks. These firms have typically not invested in very scalable systems and also don't have the critical size for their backend processes to benefit from economies of scale. Hence mid-size firms caught between the demands of an expanding market and encroaching competitive pressures are left with little choice but to outsource.

A major sea change in the mindset of mid-size firms is that they no longer view competitiveness as just an ability to get things done faster and cheaper. Today competitive advantage stems from the ability of organizations to be agile and innovative – offer better value, faster, in-tune with customer needs and ubiquitously. There is a need to increase speed to market, be more customer-centric and continually enhance internal knowledge sharing to be in sync with market demands. This allows the existing resources to become the initiators of change within the organizations where customer interactions and proximity are propelled to a level so customer loyalty becomes a permanent performance measure. All these factors are putting increasing pressure on the two critical pillars of any successful organization - human resources and business processes. Interestingly, these twin dynamics of internal cost pressures and external market demand are the two most important drivers for outsourcing – especially for more strategic initiatives.

In many ways, this is the best time for this segment to be outsourcing. Advancements in software, telecom and security systems have made outsourcing safer and more dependable than ever before. The ability to piggyback on service provider's infrastructure is an important financial benefit. Firms do not have to make significant purchases of systems and applications to compete with their larger counterparts. Service providers have become more mature and sophisticated in their service offerings. Many have developed delivery models

tailored for the mid-size firms that expect similar cost savings and benefits as larger firms but at a relatively smaller contract size.

POTENTIAL BENEFITS FROM ADOPTING OUTSOURCING

So how are mid-size firms handling these challenges that come from increasing growth and changing market dynamics? The report card is mixed on the three key, non-financial measures for assessing corporate performance – customer relationships, internal business processes and employee learning. While mid-size firms seem to be doing well compared to larger firms in enhancing customer relationships, they are lagging behind when it comes to efficacy of internal business processes and employee enrichment. This clearly indicates that these organizations are at a tipping point and need to shift their focus from running every internal function to adopting modularized processes. This key transformation can allow them to harness their resources to become drivers of business intelligence and customer relationships. Whether it is streamlining of IT or business processes, this approach logically leads towards outsourcing.

Outsourcing can be a key lever in improving employee productivity through adoption of pervasive communication strategies and resource optimization. However, organizations need to flex their rigid business models, principally by engaging in strategic relationships with outside partners that have specific core competencies, which can be leveraged to create a nimble enterprise. In this context, sourcing talent and capabilities from the global marketplace becomes a foregone conclusion. Furthermore, the focus for such relationships has to be to achieve desired outcomes – whether they are increased market share or greater competitiveness. Replicating the transaction or effort-based outsourcing engagements of the larger companies can lead to less than desired outcomes since there is no economy of scale. By shifting the model to a collaborative partnership and rewarding based on measurable business outcomes, a more symbiotic relationship can be developed.

Following are some of the key benefits that accrue from Global Sourcing, if done right:

Access Latest Technology at Lower Costs: Typically midmarket organizations are under-invested in their General & Administrative (G&A) and IT infrastructure. Lacking large financial budgets to purchase latest technology platforms and solutions, they are a prime candidate for leveraging a service provider's capabilities across both business and technology functions. With the rapid advancements in technology, changing customer demands and advent of Web 2.0, Open source and other disruptive trends, it has become challenging for smaller firms to keep up the pace. Outsourcing vendors can provide access to latest technologies at shared costs and hence lower the barriers to entry.

Opportunity to Reduce Operational Costs: Tremendous opportunity exists to reduce current operational costs, while concurrently increasing efficiencies by outsourcing business processes and technology functions to a third-party service provider. Typical target business processes include G&A functions like Finance and Accounting, Human Resources and procurement. Other G&A functions include customer care services, logistics and industry-specific services [like insurance claims processing, mortgage processing, etc.]. Typical target technological functions include Infrastructure Security, Knowledge Systems, Application Development & Maintenance, Technical Helpdesks, and Managed Services. A significant downsizing of G&A functions through labor arbitrage can contribute up to 2% additional margins to the corporate balance-sheet.

Getting Rid of Licensing Straitjackets: Mid-market organizations can reduce their budget for technology licenses significantly, as service providers carry such costs within their pricing structures. Since their service pricing is inclusive of core performance for resources allocated and efficiency enhancements, the total unit cost for such services is lower by at least 25 to 30 percent than similar in-house costs. Many providers are

also deploying “Software-as-a-Service” (SaaS) delivery models wherein companies can access the same services “On Demand” instead of “On Premise”, hence significantly reducing capital outlays and boosting returns.

Increased Business Focus of the Retained Organization: Adopting outsourcing service providers for non-core activities allows existing employees to focus on more strategic and decision-oriented roles where analysis, evaluations and customer orientation takes a front-seat. Organizations that have outsourced aggressively, have a greater ability to anticipate market changes and react to business situations since their management bandwidth is not consumed by day to day operational quagmires. A truly virtual enterprise can outsource even many of its core functions, retaining only the pieces that it considers its unique differentiators or “secret sauce”.

More Fulfilling Career Paths: Contrary to common perception, outsourcing is not about losing jobs. It’s about finding the right person to do the right job in the right location such that the delivered value can be optimized. If planned and done right, outsourcing can free up qualified resources to focus on more important and core activities, resulting in enhanced productivity and an enriching experience to the employee. This can provide more fulfilling career paths for professionals tied into G&A roles that would otherwise be mundane dead-end positions. Ultimately, satisfied employees directly contribute to their organizations’ growth and innovation, which is seen as a major fillip in an increasingly complex global marketplace.

Outsourcing meets Web 2.0: Some mid-market companies have shied away from outsourcing because they didn’t want to lose control over processes. Seeing a unique opportunity, some ISVs and service providers have merged their offerings to create a new market for blended hosted services. Among the most innovative are companies seeking to become an alternative to pure outsourcers by offering technology through a software-as-a-service (SaaS) delivery model, where HR or CRM applications are maintained by the supplier and accessed by clients via the Web. SaaS gives mid-size firms another option because they don’t have to outsource and they don’t have to maintain an expensive IT infrastructure either. While some industry watchers believe SaaS will pose a threat to outsourcing down the road, others believe the two will complement each other.

CHALLENGES

Mid-size firms face significant challenges in planning and executing major outsourcing initiatives. Compared to larger Fortune 500 firms, these companies tend to take a much larger financial risk while undertaking an outsourcing initiative and may not even have the wherewithal to emerge from an improperly executed deal. Secondly, because so little research has been done exclusively on mid-market deals, and because many deals are still so new, there’s little industry-wide data on whether outsourcing is helping companies cut costs and transform their operations.

Following are some of the major challenges that mid-size firms need to surpass in order to achieve desired ROI through global sourcing:

Lack of Readiness: Most mid-sized firms are not in the best state of readiness to embrace disruptive business models like outsourcing. Offshoring further compounds this effect when brought into the equation. This lack of readiness clearly points to the relatively low awareness of outsourcing and its intricacies at the strategic management level. As it so happens, internal readiness is one of the most critical success factors in an outsourcing initiative. Hence both at the strategic and operational level, mid-size companies have to build a consensus and a road-map to re-align their organization and seize this as an opportunity to achieve transformational gains.

Rigidity with Traditional Models: Many small to mid-sized firms have evolved from either closely-held or family-run businesses. Such ownership and organizational models contribute an added challenge to the mindset within the leadership, translating to rigidity in adopting appropriate “collaborative” and “partner-oriented” business models. Having the ability to adopt more flexible business models and the willingness to redefine functional roles within an organization are very important steps towards developing an outsourcing framework.

Bottom-line Driven: Mid-sized organizations tend to be very bottom line driven, spending a smaller percentage on R&D and innovation, resulting in increasingly commoditized service/ product offerings. This, in turn, puts significant pressure on profit margins, leading to inordinate/ unstructured cost cutting measures. In such a scenario outsourcing is often seen as a tactical necessity rather than a strategic imperative. In reality the benefits of outsourcing accrue when implemented as part of a longer term plan. Leveraging global resources purely for lower cost can provide short term benefits but often it leads to mismatched expectations and diminishing returns.

Limited Capital: Major outsourcing initiatives require substantial investment upfront to re-engineer IT and business processes as well as to transition them to a service provider. Offshoring has additional overheads which need to be considered. Savings from offshoring usually accrue after the first year, requiring a longer term perspective. Mid-size firms strapped for capital often end up taking outsourcing decisions without careful evaluation of all the alternatives.

Lack of robust Internal processes: Organizations need to have a better handle on the internal processes that they want outsourced. Typical mid-sized firms usually have undocumented or disjointed processes that are not suitable for outsourcing. As a result both during discovery and RFP phase, the internal requirements are not mapped accurately, resulting in failure of outsourced functions or loss of productivity. A decision to outsource can be an effective catalyst to re-assess process gaps and bring about transformational efficiencies.

Assume IT Solutions alone will transform businesses: Many mid-market CxOs assume that technology can fix problems and transform their company. However, owing to limited budgets, more often than not, they end up purchasing off-the-shelf applications, and end up mired in complex integration efforts. This “band-aid” approach does not address the underlying issues of lack of alignment between IT and business processes. Instead, management attention is diverted in expensive IT initiatives using staff augmentation [which is a roaring business in the US today]. Such augmentation efforts at best bring in discrete technical capabilities, and impede the organization further in its ability to integrate its business with the technologies being deployed. Hence, IT spending does not always result in better margins or reduction in time-to-market for products or services. More importantly, the learning curve the organization goes through during such implementations often results in a serious erosion of existing operational efficiencies.

CONCLUSION

The opportunity to leverage global sourcing as a business driver and tap into capabilities beyond domestic borders is significant. However, there is also an intrinsic learning curve for mid-market organizations as they begin exploring strategic partnerships with capable entities from across borders. Crucial as the challenges are, and compelling as the opportunities may be, mid-market organizations would do well to initiate serious steps at adopting outsourcing or global sourcing as a key strategic business driver in order to remain ahead of the commoditized curve. Leveraging capabilities of firms that understand the sector and its key players is a recommended way forward, in order to learn from successes while ensuring the retained organization transforms itself to a nimble and innovative one.

Prudence is necessary for mid-market organizations embracing this opportunity. Initially targeting simpler and non-critical processes for outsourcing would be the most appropriate approach to enable a learning experience. Once direct cost-savings and demonstrated process efficiencies are achieved, the scope and complexity of the initiative can be scaled to achieve more sustainable and transformational gains. Armed with this experience, organizations can then better prepare themselves for developing partnership-oriented models where the key capabilities of service providers can be leveraged. In such cases, the competency and domain experience of service providers becomes very significant, as they bring specific solutions to the table, and not just deliver services at lower costs. Therefore, the preferred approach is to leverage proven solutions with adequate customization, to suit the organization's particular nature of business, rather than implement radical initiatives or blindly imitate models adopted by their peers.

Ultimately, outsourcing is a powerful lever used to reduce operational overheads, variablize capital costs and bring in process efficiencies that can enable a competitive business model. The real successes in outsourcing are not dependent on scale or complexity or degree of offshoring – rather the most important determinant for success is - how well aligned the initiative is to the organization's business strategy and operational goals.

Global Equations is an Austin-based, global business advisory firm. We are unique in that we specialize in enabling decision making and execution of Outsourcing/Offshoring initiatives in the ITO/BPO/KPO spaces. Backed by industry leaders and consultants, we provide a complete range of services including Offshore Advisory, Market Entry, M&A assistance, and Business Acceleration services. Our presence across prime nearshore and offshore destinations like India, China, Philippines, Eastern Europe and Central America helps growing companies to expand not only across verticals, but also across geographies. Over the years, Global Equations has also been consistently ranked among the top ten boutique consulting firms in the world by 'The Black Book of Outsourcing'.

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Matryzel Consulting is an independent strategic consulting, services sourcing and advisory firm specializing in practices that have a direct influence on the services globalization industry. We assist firms with leveraging technology and knowledge, thereby enabling deployment of the most appropriate and sustainable strategic directions. This includes management of multiple complex partner relationships focused on the topline, while assisting with actual implementation of suitable business / financial models, policies, enabling structures and market development approaches that help transform strategic benefits.

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