Opinion

Financial crisis and IT outsourcing – what's next?

Alexei Miller, executive vice president, DataArt

Over the past few years, comprehensive outsourcing deals have captured the imagination of the financial services industry. Will they withstand the economic downturn?

How will the ongoing financial mayhem affect IT outsourcing? All indicators are that Wall Street troubles will trickle down to the wider economy, affecting IT service spending changes not only at investment banks and brokerages, but in other industries. To be sure, the old selling point of outsourcing – cost-cutting – is as potent as ever. However, many argue that cost alone does not drive outsourcing anymore. We believe that the outsourcing sector as a whole will experience some challenging times, with far greater segmentation, successes and failures than the arguments of yesterday would have suggested.

It may be telling to start by recalling the last broad economic downturn of 2001-2002. Since then, outsourcing firms, hot on the heels of the Y2K-fuelled run, have continued their impressive ascent, often growing at 30%+ despite their already huge size. If anything, that crisis was a blessing for the industry, which mostly sold itself under the banners of cost-cutting and business process efficiency.

A few things, however, are markedly different this time around. First, the market for offshore labour is much more saturated. Virtually every large company is actively engaged in India. Multiple 'outsourcing drives' have already shipped the most easily transferable jobs offshore. Among smaller firms, only the most orthodox in their ways have never tried to outsource. At outsourcing conferences around the world – as crowded as ever – the main topic is not how to engage an outsourcer, but how to make the best use of the engagement.

Secondly, there has been a sizeable wave of complaint about offshore services delivered from the dominant locations. Large and well-publicised contract cancellations aside, the most worrisome are comments from engineers and project managers from the client side, who are unhappy with the quality of work, products, communication gaps and, more recently, sky-high staff turnover. This in itself will not affect the offshore trend, but it expanded the ranks of those who are wary of it.

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Time for change

Thirdly, for all the talk about innovation and thought leadership, the industry at large has been too slow to innovate and lead, and too attached to the much-disliked, but often true, moniker of 'cheap labour'. The blame is shared equally by vendors, who fished for easy deals, never stopping to think about the future; and clients, who were slow to learn to trust their vendors and manage them proactively. A sad joke running among outsourcing vendors has it that you can talk the fancy talk about innovation and solving business problems, but the client will still end up saying "give me this number of bodies at that price".

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All these factors lead us to believe that the market for 'commodity' IT outsourcing services is likely to flatten. Considering how invested many IT organisations are in India, we certainly don't expect much pull-back now, when funds are scarce, but nor are we likely to see a major rally like the one at the beginning of this decade. More importantly, though, this seems to be a point beyond which generalisations about outsourcing will no longer apply. These difficult times will present an opening for those vendors who have not just preached innovation, but practised it, those who have spent their time understanding clients' business processes and strive to improve them even when "it's not in the specification". If they execute well, this will be the moment they differentiate themselves from the rest of the pack.

Generic outsourcing firms will find it increasingly difficult to maintain different offerings under one roof. After years of rapid expansion and being 'all things to all people', vendors will find that clients value specific expertise, not the standard outsourcing pitch. This reflects the maturing of the market, where increasing specialisation is the hallmark of many industries served by outsourcing. The players who can't differentiate themselves from the vast majority of commodity-like services cannot expect to see tremendous growth. The only exception to this will be the firms that understand how to execute these services with precision and efficiency.

Client caveats

For buyers and users of outsourcing, this is good news, but they must proceed with caution. There will be good deals on the market, but they may be more difficult to spot. In the short to medium term, there will be failing providers of generic outsourced labour available at a very good price, hungry for any business. While tempting, lower costs may not translate into higher value, as cost-cutting on the vendor side will exacerbate the same problems that plagued them in the good times – turnover and low-level leverage. This will be particularly true for the global financial services industry – the source of up to 40% of global outsourcing volumes, according to some estimates. Experience working for financial firms does not always translate to expertise and clients should learn to differentiate the two.

We recommend, therefore, that clients look for smaller, specialised vendors who will be willing to provide good terms, but will not look desperate. In this new world, clients will find themselves working with several specialised vendors at the same time and will need to hone a new skill – managing and bringing together teams distributed not just across continents, but across competing firms. This will never be easy, but those who master the trick will find it well worth it.