Pillsbury | Global Sourcing

Realities of Outsourcing:

8th in a Series of Webinar Presentations

Status Update on Offshoring – Where Are We Going?

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Agenda

- Impacts from globalization
- Transaction structure
- Brief history of the offshoring transaction
- Market analysis and price considerations
- Benefits and risks
- Projections over the next five years

- ***Two views:***

"Indian IT-services companies such as Infosys, Tata Consultancy Services and Wipro are putting the fear of God into the old guard, including Accenture and even mighty IBM."

The Economist, "Globalization's Offspring," p. 11 (April 7, 2007)

"India's leadership in global sourcing may be in jeopardy unless it increases its supply of skilled workers . . . . Experts at the meeting of Nasscom, the country's outsourcing group, said . . . that an incipient skills shortage was the biggest threat to the industry's blazing growth. . . . Lower-cost centers like Eastern Europe and China could become serious rivals for outsourcing business . . . ."

The New York Times, "India's Outsourcing Industry Is Facing a Labor Shortage" (February 16, 2006)

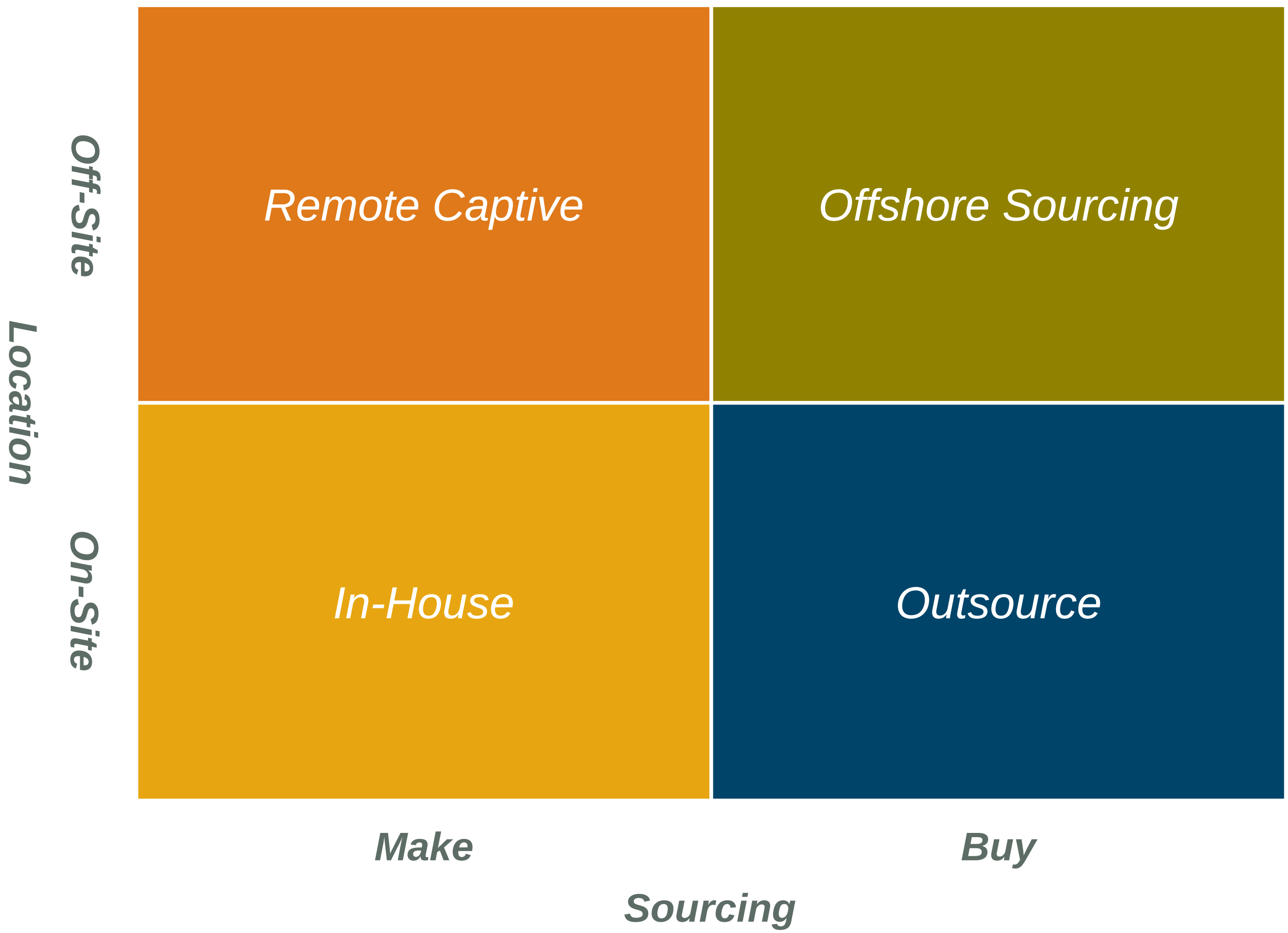
Impacts of globalization

- Globalization is having major impacts on the services market
  - Creates need to deliver services in remote locations
  - Produces extreme pressures to provide services from low cost facilities
  - Generates need for global rather than regional platforms
- Historical "move" towards 21st Century globalization (from IBM)
  - 19th Century "international model"
    - Firm based in its home country, but sells goods through overseas offices
  - Mid 20th Century "classic multinational firm"
    - Parent company created smaller versions of itself in countries around the world ("Mini-Me's")
  - 21st Century "globally integrated enterprise"
    - Rather than Mini-Me's, the company shapes its strategy, management and operations as a single global entity
- Implications
  - People, jobs and work flow to the "correct" location (Capgemini's Rightshore™; EDS' Best Shore℠)
  - These activities are fully integrated on a global scale – no more "Robber Barons"

Transaction structures

Characteristic	Onshore Outsourcing	Offshore Outsourcing
Asset Transfer	Outsourcing typically involves the transfer of people, hardware, software and third-party contracts	Offshoring typically does not involve the transfer of assets
Knowledge Transfer	Knowledge transfer is a mature process and, while not trivial, is not viewed as high risk	Knowledge transfer is a key element of both service and price, and is especially important since people often do not transfer
Term	Arrangements are typically long-term (5-7 years or more)	Contracts are often short- to medium-term (3-5 years or less)
SOW	Substantial efforts are made to develop a comprehensive SOW	Often, SOW's are developed as needed
Termination	Termination is not easy (legally or practically) and can be quite expensive	Termination is often straight-forward (both legally and practically) and without significant cost
Pricing	Often by business units (outputs)	Often by FTE-headcount (inputs)
Jobs	Domestic jobs are usually not lost	Domestic jobs are almost always lost

Sourcing "Magic Quadrant"



History of Offshore Outsourcing

- Originally focused on applications development and maintenance, which continues to be a leading domain for offshore providers
- Primary areas within applications are
  - Legacy Applications (mainframe)
  - Custom Applications (mainframe and client/server)
  - Product development (part or whole)
  - Technical components in a pre-packaged environment
  - Web technologies
- Leading industries to initially adopt offshore model were financial services, software product developers, telecommunications sector (embedded), early adopters (mainly global companies)
- Early delivery models included a significant onshore presence

History of AD/M Outsourcing

- 1988-90: Early AD/M transactions (First City Bank; Continental Airlines)
- 1991: Function Point transaction (Continental Bank)
- 1996: Balanced Scorecard transaction (J.P. Morgan)
- 1997-99: Co-sourcing; Andersen Consulting approach (Bankers Trust)
- Y2K Interruption
- 2001 - Offshore outsourcing
- Major themes
  - AD/M has always been part of the outsourcing landscape
  - Focus has always been on alternative methods to measure output, productivity and quality
  - Only mixed success has been achieved

Initial factors leading to offshore popularity

- Globalization – companies with globally integrated delivery models have significant competitive advantage
- Economic downturn leading to cost reduction mandates
- Offshore has become an established business practice
  - Cost, quality, and productivity have been optimized by offshore service providers mitigating risks for customers
  - Benefited from starting from scratch
    - "They are unencumbered by the accumulated legacies of their rivals. Infosys rightly sees itself as more agile than IBM, because when it makes a decision it does not have to weigh the opinions of thousands of highly paid careerists in Armonk."

      The Economist, "Globalization's Offspring," p. 11 (April 7, 2007)
- Advances in telecommunications and other infrastructure
- IP protection from governments in offshore locations

Applicable market factors

- Domestic outsourcing is an established business practice in the areas of infrastructure systems management and applications management
- Domestic outsourcing service providers are positioning themselves in business process outsourcing (BPO)
- Offshoring is an established business practice in applications area
- Offshore service providers are repositioning themselves in business process outsourcing
- Domestic outsourcing service providers are establishing offshore centers to provide increased cost savings
- Offshore service providers are establishing alliances with local companies to expand their footprint
- Domestic outsourcing service providers now consider the top offshore service providers as a competitive threat

Expanding scope of "offshored" services

Applications

- Application Development
- Applications Support
- Platform migration
- Enterprise Applications
  - SAP, Oracle, People Soft
  - CRM, SCM
- Web Technologies
- EAI / B2B
- Embedded Programming

IT Infrastructure

- Technical Help Desk
- Remote data center support
  - Level 2 Support
  - Systems Operations
  - Systems Administration
  - Production job monitoring
  - Network Monitoring

BPO

- Customer contact center
- Telemarketing
- Web sales
- Billing services
- Claims processing
- Back office accounting
- Benefits administration
- Tax processing
- Stock analysis
- Banking back office

Fragmented competitive landscape

- Pure play offshore service providers
  - Typically, non-US companies with majority of operations based offshore
  - Established pure play companies are traded on NASDAQ or NYSE
- Domestic service providers
  - Traditional outsourcers with operations located offshore
  - Outsourcers with globally integrated capability have a competitive edge
- Joint Ventures / Alliances
  - Domestic companies with alliances with pure play offshore providers
  - Domestic companies providing niche industry expertise / customer relationships

Challenges of offshore outsourcing

- ***Still*** early stages of life cycle
  - Size of Indian offshore activities still only a fraction of the large multi-national companies
- Unique issues confront buyers at strategic and tactical level
- Differentiate myth from reality
- Shifting trends in ITO, AD/M, and BPO
- Major issues
  - ability to scale operations
  - business continuity
  - confidentiality and non-disclosure
  - over-zealous competition
- Challenges to be addressed (from Nasscom Fact Sheet)
  - augmenting talent supply
  - creating world-class infrastructure
  - strengthening information security
  - enhancing operational excellence
  - providing regulatory support
  - catalyzing domestic market developments
  - fostering an ecosystem for innovation

"Pure Play" - Considerations

Issues / Challenges

- Management
- Ability to continue expanding and growing
- Stability
- Flexibility
- Adaptability to US culture
- Competitiveness
- Domain expertise
- Product portfolio
- People, process, technology

- TCS
- Infosys
- Wipro
- Satyam
- HCL Technologies
- Cognizant
- Mastek / Majesco
- L&T Infotech

Multi-national outsourcer - Considerations

Issues / Challenges

- Commitment to offshore - confirmed
- Global integration
- Geography
- Organizational alignment
- Product positioning
- Build or buy
- Process alignment

- IBM
- EDS
- Accenture
- CSC
- HP
- Cap Gemini
- Siemens
- ACS
- Perot
- CGI

- Worldwide trends
  - Domestic as well as pure play offshore providers are becoming geographically diverse
    - Brazil, Mexico, China, and Malaysia
    - But, need to distinguish whether work is being performed for the local (domestic) market – like China – or for export to the US and Europe
  - New “popular” areas of offshoring are being marketed aggressively:
    - Remote infrastructure management
    - Pharmaceutical research and development
    - Product engineering
- India trends
  - Domestic service providers have increased their presence significantly in India
  - In India, Tier 2 cities such as Pune are seeing more growth
    - Tier 1 cities are plagued with high levels of attrition
  - Captives (especially in India) are becoming more common for multi-national companies as they enter to market their own services

Labor pricing trends

- Competition for skilled resources is intense
  - Salaries in India continue to grow at 15%
  - However, prices have not yet been impacted
- Staffing mix at offshore locations based on “years of relevant experience” and “years with company” must be scrutinized
- Domestic service providers’ pricing for offshore rates is very competitive as compared to Tier 1 offshore providers
  - Not necessarily true four years ago
- Margins on offshore portions of service delivery is as high as 35% for both domestic and offshore providers
- “Captives” still trumps “sourcing” from cost perspective, but there are other concerns
  - Establishing an offshore captive does not make sense for most companies
- Offshore providers are still not involved with “transfer of operational resources”

AD/M Pricing (India Rates)

Labor Category	Range
Project Manager	28 - 32
SAP	
Functional	24 - 30
Technical ABAP	17 - 23
Technical BASIS	20 - 30
Oracle Apps	24 - 30
Windows Administrator	19 - 24
Unix Administrator	19 - 28
Database Administrator	22 - 28

F & A Outsourcing (India Rates)

Function	Process	Range
Procure to Pay	Payables & Supplier Accounting	12 – 14
	Product Accounting	15 – 17
Order to Cash	AR, Cash Apps	24 – 30
	Credit, Collections	17 – 23
Record to Report Performance Mgmt	Inventory Accounting GL, GA	16 – 18

Pricing comparison by geography

F & A Outsourcing – Domestic Service Provider (US$ per Month)

Labor Category	Midwest	Bangalore /Chennai	Shanghai	Dalian	Bratislava
Client Service Manager	28,000				
Delivery Center Lead	22,000	13,000	19,000	13,000	15,000
Process Lead	18,000	9,000	14,000	8,000	12,000
Team Lead	12,000	3,000	7,000	4,000	6,000
Accountant	13,000	3,000	7,000	4,000	6,000
Clerk	9,000	2,000	3,000	2,000	4,000

- Two primary risk factors for labor pricing are
  - Wage inflation
  - Foreign exchange rates
- So far these factors have not impacted the prices due to competition and shifting staffing mix
  - Overall cost of doing business in India versus labor costs
- Cost to the customer is still strongly dependant on “solution” rather than just hourly rates
  - Mix of offshore versus onshore labor
  - Speed of transition and quality of knowledge capture
  - Estimated number of people to perform the work and the hours to be consumed
- Competition and leverage are key to obtaining the best “value” for client
- ***Note:*** Income Tax (STPI) “Holiday” for Indian companies scheduled to expire in 2009 – either shift risk to supplier or include in budget

- Legal perspective: key offshoring issues
  - Dispute resolution; even more important than usual
    - International disputes are more expensive and complex
  - Data protection and privacy
    - India still has no data protection framework
  - Intellectual property
    - Offshore suppliers may be more accommodating on IP issues
      - But, re-use may still occur
  - Tax
  - Immigration
    - Citizen employees and green card holders been sent abroad
    - Foreign nationals working in the US on temporary work visas
  - Labor laws
    - In India, employee related laws generally rest with supplier if foreign entity has no contractual relations with supplier’s employees
      - Contract should make this clear
  - Export laws – be careful

Risk allocation issues

- Also, some “typical” contract issues should be given particular attention
  - Business continuity
  - Supplier viability – financial due diligence
  - What is being outsourced: core versus non-core business functions
- Other offshoring-specific Issues
  - Language / cultural
    - Governance
    - Customer-facing communications
  - Time zone differences – India versus Central America, for example
  - Onshore – Offshore mix: retaining sufficient control within onshore operations while providing sufficient offshore scope to drive savings
  - If considering a captive offshore operation, ensure that it is large enough to attract and keep skilled talent in offshore country (particularly in India)
  - Knowledge transfer – is there a commitment for customer personnel to visit offshore supplier?

- Offshore!!! Going forward what does it mean?
  - Applications development and maintenance -- yes
  - Back-office, paper-intensive processes -- yes
  - Call centers, help desks, etc. -- yes, but (general move from India to Philippines)
  - Functions are generally client focused, not dealing with the client's customers
- Major driver going forward: expand the types and scope of work performed offshore
  - But, beware the pitfalls: for example, recent $100 million fine against ITT for violating export control regulations (see appendix)
- More importantly, offshoring is fundamentally changing how suppliers provide and deliver their services
  - This is part of the suppliers' response to the issues previously noted
  - May not be a direct challenge to indigenous Indian providers
  - Key: in what manner and how effectively do the multi-national company providers ***continue*** to adopt, embrace and expand offshore supply?
    - What are the impacts in the local, offshore domestic market?
    - Recent study by Value Leadership Group, "European IT Companies in India"
  - Political objections to offshoring exist, cannot be ignored, but ultimately will not impede the trend to offshore supply
    - US 2008 elections provide opportunity for issue to resurface

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Client Alert

International Trade
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Major Export Controls Penalty Signals New Scrutiny of Defense Sector Outsourcing

by Nancy A. Fischer and Sanjay Jose Mullick

On March 28, 2007, the U.S. Department of Justice announced that ITT Corporation had agreed to pay fines totaling $100 million for unauthorized exports of night vision equipment technology to offshore vendors to whom it had outsourced aspects of their production. On April 11, 2007, the U.S. Department of State announced that ITT's Night Vision Division would also be prohibited from exporting defense-related equipment and technologies for up to three years. These penalties send a clear message that the U.S. government will be looking closely at outsourcing in the defense sector. Companies engaged in such outsourcing should ensure that they are compliant with U.S. export controls.

ITT Will Pay $100 Million Penalty

ITT is a leading supplier of defense systems to the U.S. military, including night vision equipment. It had subcontracted production to certain offshore entities. According to the Justice Department, among other violations:

- ITT exported or caused to be exported drawings, specifications and services for night vision goggle systems to China, Singapore and the United Kingdom without an export license or export authorization;
- ITT provided night vision optical assembly technical data to a company in Singapore that exceeded the scope of its export license;
- ITT provided night vision equipment design specifications to an employee at a U.S. company knowing he would export it to a company in Singapore; and

- ITT shared switch designs with a company in Japan, despite being on notice that the company would outsource some of the switch manufacturing, assembly and testing to a Chinese firm.

ITT will pay a $2 million criminal fine to the Justice Department and a $20 million civil penalty to the Department of State; will forfeit $28 million to the United States as the proceeds of its illegal actions; and will invest $50 million in the development of advanced night vision technology for the U.S. Armed Forces. The handling of the case as a criminal matter and the mandated expenditures in new technology are two aspects that make the settlement unique. The government also barred ITT from making defense-related exports and from contracting with the Department of Defense for a period of one to three years.

The ITT penalty serves notice that the U.S. government is going to take a close look at outsourcing in the defense sector. *The Wall Street Journal* reported “[f]ederal law-enforcement officials are expanding their scrutiny of outsourcing by defense contractors,” and “[t]he ITT case is bound to send shivers through the U.S. defense industry.” A Justice Department official stated “[w]e hope the agreement with ITT will send a clear message that any corporation who unlawfully sends classified or export-controlled material overseas will be prosecuted and punished.”

Defense Sector Export Controls

The Department of State’s Directorate of Defense Trade Controls (DDTC) administers U.S. export controls on goods, software, technical data and services that are considered defense articles or services under the Arms Export Control Act. These are listed on the U.S. Munitions List (“USML”), which is contained in the International Traffic in Arms Regulations (“ITAR”). Many items that are not exclusively defense-related but are considered to have significant military applicability (e.g., night vision equipment, communications satellites and militarily sensitive electronics) are on the USML and are controlled for export under the ITAR.

What constitutes an “export” is broader than might be assumed. In addition to shipments of hardware abroad, exports include:

- e-mailing software offshore;
- providing IT support personnel who are not U.S. persons access to ITAR-controlled technical data on computer servers located in the U.S. or abroad;
- discussing technical details of defense articles with offshore entities or non-U.S. persons; and
- working with offshore engineers to develop defense-related software for U.S. government contracts.

Exports and re-exports of U.S.-origin defense articles and services to certain countries are prohibited. Otherwise, with only certain narrow exceptions, such transactions require prior approval from the DDTC. The two most common forms of export authorization are:

- **DSP-5:** an export license that may cover multiple shipments of hardware up to an amount identified in the license, or a single shipment of ITAR-controlled technical data (e.g., technical manuals); and

- **Technical Assistance Agreement (TAA):** an agreement between a U.S. exporter and a foreign recipient for the export of technical data and defense services. A TAA governs what may be exported and with whom it may be shared.

Because a TAA covers ongoing exchanges of technical data or the provision of defense services, such as technical dialogue between the U.S. and foreign parties, it would likely be the type of authorization required to engage in an outsourcing arrangement.

The Importance of Compliance

Companies that deal with ITAR-controlled items, or technical data associated with such items, must be particularly careful to avoid unauthorized exports in their offshore outsourcing activities. Violations of export controls can carry severe fines and penalties, including imprisonment and revocation of export privileges and business licenses. Export control compliance must be comprehensive because the exporter is primarily liable and the compliance responsibility cannot be contracted away to other parties to the transaction.

Effective compliance requires understanding which transactions constitute exports and which items may be subject to ITAR restrictions. It also involves ongoing obligations; for example, exporters are often required to implement specific mechanisms for safeguarding goods and technical data released under ITAR export licenses and are subject to continued monitoring by the Department of Defense. This means exporters must implement measures to ensure that – even after export authorization is obtained – transactions are carried out in accordance with that authorization.

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