# OUTSOURCING: WHO, WHERE, AND WHY

## Results from the 2004 Enterprise Strategies Outsourcing Survey


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## The 2004 Enterprise Strategies Outsourcing Survey

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# PART I: THE WHO AND WHERE OF OUTSOURCING

In the first of our five-part series, we examine who's outsourcing and where the projects are headed—offshore, near-shore, or kept at home.

Love it or hate it, outsourcing is here to stay. In fact, it's likely that outsourcing will become even more pervasive over time: With costs savings pegged at between 20 and 55 percent, it's a strategy few CEOs can afford to ignore.

Among the controversies: job losses to foreign countries, a particularly touchy subject in an election year.

The controversy over outsourcing obscures an important finding from our survey respondents: comparatively few organizations that participated in our survey are actually sending jobs overseas. In fact, of the companies that have outsourced some (or, in rare cases, all) of their internal applications, services, or operations, relatively few have contracted with offshore providers.

While more organizations will undoubtedly experiment with offshore outsourcing over the next few years, it's just as likely that many are going to be dissatisfied with these experiences. On top of this, there's a healthy market for domestic outsourced services, which typically grab the lion's share of mega-buck deals, our respondents say—70 percent prefer domestic providers.

The reality is that many companies are offshoring with relatively small applications or services (typically of $100,000 or less) and for decidedly finite periods (almost half outsource on a per-year basis)—both of which seem indicative of a pragmatic—rather than a steadfast—comportment to offshoring.

## TABLE I: SUCCESS FACTORS

In your experience, what is the most important factor in successful sourcing projects?

| | |
|---|---|
| Understanding the goals | 27.8% |
| Selecting the right vendor | 24.5% |
| On-going management | 19.9% |
| A properly structured contract | 12.5% |
| Strategic vision | 7.1% |
| No previous experience | 5.7% |
| Other | 2.5% |

Source: 2004 *Enterprise Strategies* Outsourcing Survey
Results for all respondents answering question

These are among the most salient findings of a recent survey of 744 organizations conducted by *Enterprise Systems.* Survey respondents were drawn from a broad range of industries, including outsourcing-friendly verticals such as advertising, aerospace, financial services, manufacturing, retail, and telecommunications. Nearly 29 percent of respondents identified themselves as directors, CIOs, and CEOs; another 22 percent were managers, and 49 percent told us they were IT staff, consultants, coordinators, or consultants.

## TABLE 2: NUMBER OF OUTSOURCING PROVIDERS

How many sourcing providers did your most recent sourcing project involve after the final contract was signed?

| | |
|---|---|
| 1 | 53.4% |
| 2 | 19.0% |
| 3 | 5.7% |
| 4 | 3.7% |
| 5 | 0.9% |
| 6-10 | 2.0% |
| 11 or more | 1.8% |
| Don't know | 7.7% |
| Haven't signed contract yet | 6.0% |

Source: 2004 *Enterprise Strategies* Outsourcing Survey
Results for all respondents answering question

What did respondents have to say about outsourcing? Some acknowledged being conflicted about outsourcing of any kind—including the domestic variety. Others registered their adamant opposition to outsourcing of the offshore-type. Several—typically respondents who endorsed the outsourcing-ultimately-evens-out theory of economic activity—said they were just trying to do what they felt was best for their organizations.

"One of the things you have to understand" about domestic outsourcing is that "you're cutting loose people who may have a hard time catching on somewhere else for remotely the same [compensation]," says a director of systems development with a U.S.-based firm.

This executive doesn't believe that domestic outsourcing has to be a zero-sum proposition, however; if an outsourcing provider truly is a best-of-breed vendor at what it does, he reasons, it should be able to compensate its employees accordingly: "If we outsource someone's job, we try to make sure the contractor will rehire them [to do it] at close to their old salary."

Elsewhere, we found signs that offshore outsourcing doesn't have a monopoly on executive mindshare, either. In fact, we heard from several executive respondents who admitted to qualms about the practice. "Between the competing claims" of offshore outsourcing proponents and detractors, "I just don't know what to think," admits an executive with a U.S.

automotive manufacturing firm. "I also don't know if companies who do [go offshore]—I don't know if that [outsourcing arrangement] is a long-term thing or if just won't work out for them. I don't think anyone really knows that."

## Who's Outsourcing Now?

Not surprisingly, one-third of respondents (33.4 percent) to our survey are currently outsourcing some or all of their applications, services, or operations. This total includes a 23 percent tally from organizations that are in the governance stage of their outsourcing arrangements, along with an additional 10.4 percent that are renegotiating terms of existing outsourcing contracts with their providers.

That's far from a majority, however. As a matter of fact, it's not even a simple plurality: A combined 42.8 percent of respondents are currently evaluating outsourcing providers, while another 23.9 percent have no outsourcing plans at all (or simply don't know what their outsourcing plans are).

Nevertheless, the momentum is clearly behind outsourcing: 85.4 percent of current or prospective outsourcers (i.e., at some stage of the outsourcing process) have also farmed out work in the past.

### TABLE 3: STAGE OF OUTSOURCING PROJECT

For your most recent sourcing project, what stage in the process is your organization in?

| | |
|---|---|
| Assessment | 21.1% |
| RFP | 9.6% |
| Selection | 12.1% |
| Governance | 23.0% |
| Renegotiation of contract | 10.4% |
| Don't know | 11.0% |
| Other | 12.9% |

Source: 2004 *Enterprise Strategies* Outsourcing Survey
Results for all respondents answering question

Across all companies in the sample, 21.1 percent are assessing prospective outsourcing projects; an additional 9.6 percent have already solicited RFPs from potential providers; and 12.1 percent are in the post-RFP selection process. Assuming only that organizations which are at the RFP and selection stages—and aren't merely assessing potential outsourcing plans—ultimately commit to outsourcing strategies, a slim majority—52.1 percent—will be in the outsourcing camp.

## Where Are They Going—
## Offshore vs. Domestic Outsourcing

Even though the term "outsourcing" has become synonymous with the practice of sending jobs overseas, the bulk of outsourcing activities—70.2 percent—occur on the domestic front, according to respondents to our survey. In fact, only 21.5 percent of respondents say they've gone the offshore route, while another 2.8 percent have invested in "near-shore" options (e.g., Canada and Mexico).

Of companies that have solicited RFPs, a majority—almost 69 percent—says they plan to tap the services of domestic outsourcing providers, while an additional 20 percent expect to use offshore providers. Eleven percent did not specify a preference for domestic, near-shore, or offshore providers.

### TABLE 4: WHERE PROJECTS ARE HEADED

Is the primary service provider in your most recent sourcing project a firm whose headquarters are:

| | |
|---|---|
| Domestic | 70.2% |
| Offshore | 21.5% |
| Near-shore | 2.8% |
| No service provider selected yet | 5.5% |

Source: 2004 *Enterprise Strategies* Outsourcing Survey
Results for all respondents answering question

### THE CONTROVERSY OVER OUTSOURCING

No doubt about it—outsourcing is a bitterly divisive phenomenon. That's because outsourcing no longer simply describes what happens when organizations farm out in-house jobs to domestic best-of-breed contractors. These days, "outsourcing" figures a trend in which high-paying U.S. jobs are sent offshore, to such far-flung locales as Bangalore, Beijing, Jakarta, and even Saigon.

Outsourcing, then, is a tendentious thing. Proponents—including prominent economists such as N. Gregory Mankiw, the chairman of the White House Council of Economic Advisors, and J. Bradford DeLong, a professor of economics at the University of California Berkeley—argue that outsourcing (yes, even the offshore-type) is an essential aspect of free trade that, on balance, creates as many new domestic jobs as are lost.

"The immediate effect of an increase in offshoring is a reduction in U.S. employment, either through a rise in worker layoffs or a slowdown in new job creation," writes Charles Schultze, a senior fellow emeritus in Economic Studies at The Brookings Institution, a progressive think tank. "Over the longer run, however, the lower prices for consumer and investment goods made possible by the offshoring raise real wages and living standards here at home while consumption and investment spending rise and employment recovers."

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Among organizations that have completed the RFP process, a significant number (almost 80 percent) plan to tap the services of domestic outsourcing providers. In fact, just 11.3 percent of companies that have completed RFP evaluations plan to go the offshore route, while 4.5 percent expect to outsource to near-shore providers. An additional 4.5 percent did not specify a preference for domestic, near-shore, or offshore providers.

Most of these companies—52.8 percent—generate less than $500 million in annual revenues. This helps underscore the advice of many outsourcing veterans, who counsel that there are trade-offs—in the form of miscommunication, lack of direction, business misalignment, and other issues—associated with the low-cost offshore model. For some small and mid-sized enterprises (SMEs), these trade-offs may pose unacceptable risks.

"There must be maintained a significant local company influence to offset or counteract" offshoring's negative long-term effects on business quality, competitive response, and general flexibility, says a consultant with a prominent insurance company who has been involved in both domestic and offshore providers outsourcing efforts.

"Not that it can't work, just that it has much more opportunity to fail. If you retain the same vendor, the problems may disappear over time as they become more seasoned, but then you may lose on competitive pricing," he says. How does this consultant explain the success of offshore outsourcing? "[T]he company gets … a win for playing the game for investors," he points out, conceding that "you get a bigger up-front success hit" in terms of cost savings, with a decline in ROI as a company becomes more vested in the offshore experience.

## Revenue Size Matters

Large enterprises with $500 million or more in annual revenues are much more likely than smaller organizations to send jobs offshore.

But a chorus of detractors—including prominent economic heavyweights such as Nobel Laureate Paul Samuelson and economist Ralph Gomory, president of the Alfred P. Sloan Foundation—is increasingly challenging that orthodoxy. The result is a highly charged debate that's as partisan as any political contest. "If the wage differential between two trading countries is sufficiently large, the loss of industries to the low-wage, underdeveloped country may well benefit both countries at the national level," Gomory told Congress earlier this year. "However, as the underdeveloped country develops and starts to look more like the developed one, the balance turns around and further loss of industries becomes harmful to the overall welfare of the more developed nation."

Financial services giant Goldman Sachs estimates that as many as 400,000 services jobs were sent offshore over the last four years. The Information Technology Association of America (ITAA) reports that just over one-quarter of that total—104,000 jobs—consisted of IT-related positions.

These and other forecasts shouldn't overshadow an important point, however. Outsourcing has been a viable strategy since at least the 1980s—when organizations first began farming out call centers and other service-oriented operations—and the offshore variety of outsourcing has itself been with us for over a decade. Offshore powerhouse iGate Corp.—the parent company of iGate Global Solutions—was founded in the late 1980's, for example, and American Express first began outsourcing some of its operations to India in the early 1990s.

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As it is, an overwhelming majority (97.3 percent) of companies in the $500 million and up category outsource—or are otherwise thinking about outsourcing—to domestic, near-shore, or offshore providers. Of these, 63.6 percent are currently outsourcing—or mulling over decisions to outsource—applications, services, or operations with domestic providers. What is surprising is that this figure is well below the average (70.2 percent) for all companies.

Conversely, 36.3 percent of $500 million and up organizations are currently outsourcing, or are thinking about outsourcing, with near-shore or offshore providers. That's well above the average (24.3 percent) for all companies.

This disparity grows with each additional billion-dollar increment of revenue. Among companies with $5 billion or more in annual revenue, for example, 53.5 percent have or are mulling outsourcing arrangements with domestic providers. But nearly 43 percent currently outsource—or are otherwise thinking about outsourcing—with offshore providers.

At a certain point, the two extremes even reach parity: 48.4 percent of companies with $25 billion or more in revenue have contracted or are thinking about contracting with domestic services providers; while 48.4 percent have—or are considering—relationships with near-shore or offshore providers.

This parity is short-lived, however, as revenue increases. Among companies with $50 billion or more in revenue, only 43.5 percent currently outsource, or are thinking about outsourcing, to domestic services providers. Instead, 52.2 percent are pursuing relationships with near-shore or offshore providers.

Many companies, then, have some experience with outsourcing—of the domestic, near-shore, and offshore types.

Our survey respondents weren't asked to disclose whether they plan to make offshore moves over the next few years, but there's evidence the offshore tally could skyrocket in the not so distant future. Two years ago, consultancy Forrester Research famously predicted that about 3.3 million U.S. services jobs will be sent overseas by 2015—a projection the firm believes is still accurate. This summer, however, Forrester revised this estimate for the near term, citing a number of factors—including the prominence of outsourcing, which has encouraged many fence-sitting companies to go offshore to protect themselves competitively—it believes could lead to a short-term bump in offshore outsourcing activity.

Some experts, such as Cynthia Kroll, a senior regional economist at U.C. Berkeley's Haas School of Business, believe the offshore phenomenon could have an even more significant effect, such that as many as 14 million U.S. services jobs—that is, approximately 11 percent of the overall workforce—could be in play. Nevertheless, Kroll—like many of her colleagues—has a pragmatic take on the offshore phenomenon: She points out, for example, that the loss of 250,000 high-tech manufacturing jobs during the 80's and 90's was more than offset by the addition of 1.5 million services jobs over the same period.

Finally, it's possible that firms that have outsourced applications or operations to domestic providers have also—perhaps unknowingly—sent them offshore. IT services giant EDS, for example, has partnered with Satyam Computer Services Ltd, a provider of outsourcing services based in Hyderabad, India. Professional services companies are getting into the game as well: Deloitte Consulting, for example, has notched an agreement with iGate Global Solutions, an outsourcing giant with extensive operations in India.

# PART 2: MORE THAN JUST CUTTING COSTS

What's motivating survey respondents to move projects to other providers? Despite a popular notion, it's not just about cutting costs.

Conventional wisdom has it that a mandate to reduce costs, more than any other factor, is driving the rush to outsource. In one celebrated case, for example, professional services firm McKinsey & Co. estimated that offshore outsourcing can reduce an organization's costs by anywhere from 45 to 55 percent.

U.C. Berkeley's Kroll says the potential cost-savings resulting from successful outsourcing experiences are in some cases staggering—particularly for organizations with extensive operations in high cost centers, such as the Silicon Valley. "The savings to a company from shifting work overseas can be very large," said Kroll in testimony before the Senate in March. "[W]ages in some occupations may be less than one-tenth the U.S. wage, and the gap is even wider for firms located in [the] Silicon Valley."

To some extent, this is born out by feedback we received from respondents, 25.5 percent of whom listed a mandate to reduce or control costs as the number one reason to outsource, and 24.7 percent of whom also cited price as the most important consideration they take into account when selecting an outsourcing services provider. What's more, a far greater number of executives (26.4 percent) rated pricing as the second most important selection factor, with only 16 percent identifying proven competency. All told, 51.1 percent of respondents rated pricing as the first or second most important factor in their outsourcing selection calculus—while only 44.8 percent identified proven competency.

Our survey also found that companies that valorize price tend to break for near-shore or offshore service providers at a clip (39.4 percent) that's significantly higher than is typical (23.4 percent) for the combined near-shore and offshore segments of our total respondents.

## TABLE 5: WHY OUTSOURCE?

Why did your company decide to outsource its latest IT sourcing project? (Check all that apply)

| | |
|---|---|
| Reduce or control costs | 25.5% |
| Gain access to IT resources unavailable internally | 16.5% |
| Free up internal resources | 16.1% |
| Gain access to high quality resources | 14.0% |
| Accelerate project | 14.0% |
| Improve business focus | 10.6% |
| Reduce time to market | 6.6% |
| Accelerate company reorganization/transformation | 5.5% |
| Gain access to management expertise unavailable internally | 3.9% |
| Other | 3.4% |
| Don't know | 1.7% |

Source: 2004 *Enterprise Strategies* Outsourcing Survey Results for all respondents answering question

Likewise, 60.6 percent citing cost reduction or control as a prime outsourcing impetus choose to partner with domestic service providers. This is well below the overall average for the domestic outsourcing segment (70.2 percent).

But price, it would seem, is also a *secondary* consideration for many decision-makers: An even greater number of respondents—almost 29 percent—rated an outsourcing provider's proven competency in a given area as the most important consideration. In response to our "Why outsource?" question, 74.5 percent of respondents cited reasons *other* than pricing or cost control.

The simple upshot, the director of IT infrastructure for a global investment management firm told us, is that outsourcing decisions should never be made on the basis of cost savings alone. Instead, this person argues, organizations must give particular weight to the "alignment of the [outsourcing] organization's price and model" with their own needs.

## TABLE 6: SELECTING A SERVICE PROVIDER

What was the most important factor in selecting the service provider?

| | |
|---|---|
| Proven competencies | 28.8% |
| Price | 24.7% |
| Commitment to quality | 14.6% |
| Don't know | 5.8% |
| References and/or reputation | 5.2% |
| Scope of resources | 5.2% |
| Other | 5.0% |
| Flexible contract terms | 4.9% |
| Cultural fit | 3.3% |
| Geographic location | 2.5% |

Source: 2004 *Enterprise Strategies* Outsourcing Survey
Results for all respondents answering question

In this respect, he says, the decision to outsource involves an altogether more complex calculus. "What are my outsourcing requirements? What am I trying to achieve? What tier players should I be considering—whether domestic, near-shore or off shore—[and] what are the current experiences or challenges of existing clients with these vendors?"

Respondents gave a range of additional reasons for selecting outsourcing providers, of course. Next to cost and proven competency, the third most-frequently cited factor—listed by 14.6 percent of respondents as the most important overall factor—concerned a provider's demonstrable commitment to quality (15.2 percent also listed this as the second most important overall factor).

Other factors included the scope of resources provided by an outsourcing vendor (5.2 percent ranked it first, 7.2 percent ranked it second); a provider's reputation and the testimony of customer references (5.2 percent, 6.9 percent); and an outsourcer's willingness to provide flexible contract terms (4.9 percent, 6.3 percent).

## Beyond Price

Many companies conceive of outsourcing not just as a means to cut costs, but also as a way to more effectively deliver new applications or services, boost efficiencies, and make their businesses more competitive, to boot.

For example, 16.5 percent of respondents opted for outsourcing in order to gain access to IT resources that would otherwise be unavailable to them internally. Many of these (56.7 percent) are companies with less than $500 million in annual revenues, which dovetails very nicely with the shopworn image of cash-strapped small and medium enterprises (SME) struggling to keep pace with their bigger competitors.

Similarly, 14 percent of respondents singled out outsourcing as the best way to gain access to "high quality" resources, presumably in the form of skills, hardware, software, etc. Once again, the breakdown of SMEs versus large enterprise environments follows a familiar pattern: 61.8 percent to 38.2 percent.

Clearly, then, cash-strapped SMEs aren't the only ones that have embraced outsourcing as a means to more effectively deliver new—or better—applications, services, processes, or other resources.

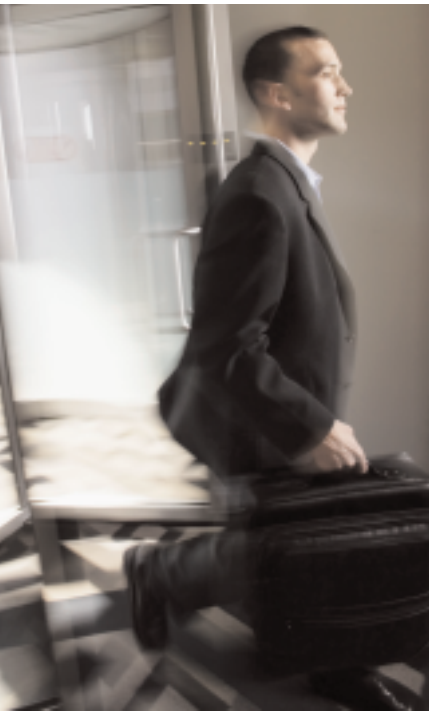
Elsewhere, 16.1 percent of respondents have embraced outsourcing as a strategy to free up their existing IT resources. Here again, the timeless image of the scrappy SME competitor trying to make the most of what it has is reflected in the data: A majority of these companies (56.3 percent) generate less than $500 million annually. A surprising number of organizations with annual revenues in excess of $500 million (43.7 percent) and $1 billion (35 percent) say they've embraced outsourcing for the same reason.

Thanks to outsourcing, Six Sigma-esque strategies such as IT and business realignment or process improvement aren't just for the big boys, either. About one in ten (10.6 percent) respondents believe outsourcing will help them focus more effectively on business concerns; of these, 44.8 percent are SME shops with annual revenues of $500 million or less. What's more, nearly a quarter (22.4 percent) of these SMEs help put the word "small" in the term "small enterprise," with revenues of less than $100 million annually.

Consider, too, project management, which—to be fair—is the bane of all companies great and small. Fully 14 percent of respondents identified project acceleration as their foremost outsourcing driver; of these, 44 percent were SMEs and 56 percent were large enterprises. The lesson is clear: Outsourcing is anything but the exclusive provenance of the billion-dollar-and-up organizations.

# PART 3: WHAT GETS OUTSOURCED—AND WHERE IT GOES

What types of projects are our survey respondents most likely to outsource? From application and Web site development to help desk support, we examine what activities are on the move.



An entire class of jobs (i.e., service-oriented positions) is being outsourced, and some experts argue that a wide-range of professions—from programmers to accountants to radiology technicians—could eventually be outsourced to points east and west of the U.S.

"Services jobs can be outsourced if they are primarily back-office jobs, requiring little customer interaction. This is particularly likely to occur in jobs where the major 'product' is information," said U.C. Berkeley's Kroll in her testimony. "The ability to move the product over remote communications networks has also made it much easier to move these jobs abroad. The jobs most likely to go are those where the wage differential is high, and where the social interactions among workers in these occupations is not a key component of the industry's success."

IT isn't insulated from this phenomenon. By the end of 2004, for example, market research firm Gartner Inc. predicts that one out of every 10 IT jobs will be outsourced overseas. For the moment, however, most IT jobs are staying here. In fact, even in skill areas in which offshore providers are widely assumed to have built-in advantages the majority of IT jobs are staying put. In other functional areas—such as the security sector and the market for managed network services, for example—domestic service providers may have built in advantages versus their competitors in offshore locales.

## Application Development

In a scene from the film *Office Space,* a frazzled middle manager-type is trying desperately to justify his job—as a liaison between customers and software engineers—to a pair of cost-cutting consultants.

After he's made his case, albeit imperfectly, one of the pointy-headed duo asks a loaded follow-up question: "Why couldn't the customers just take [their requests] directly to the software people, huh?" To the frazzled middle-manager type—and to thousands of American companies—the answer is obvious: "Because engineers are not good at dealing with customers!"

That perception may explain why application development tasks are among the most likely to be outsourced by U.S.-based firms.

Consider this: 20.6 percent of respondents say their most recent sourcing project was for application development responsibilities. That's nearly double the tally for the next-highest area (Web site development and management) at just 12 percent.

Of respondents who outsourced their application development tasks, 54.6 percent selected domestic providers. That's significantly below the overall average (70.2 percent) of companies that outsource domestically. On the other hand, 40.6 percent of organizations outsourced some or all of their application development responsibilities to near-shore or

## TABLE 7: WHAT FUNCTIONS ARE OUTSOURCED

What information technology work is being outsourced in your most recent sourcing project? (Check all that apply)

| | |
|---|---|
| Application development | 20.6% |
| Web site development/management | 12.0% |
| Help desk support | 10.6% |
| Network operations | 8.9% |
| Data center operations | 8.6% |
| Application management | 8.6% |
| Customer support | 8.3% |
| Security | 6.2% |
| All IT functions | 5.1% |
| Other | 4.6% |
| Architecture | 4.2% |

Source: 2004 *Enterprise Strategies* Outsourcing Survey
Results for all respondents answering question

offshore providers. That's nearly double the combined near-shore and offshore average of all survey respondents (24.3 percent). (See sidebar, *The Attraction of India,* for more.)

In our survey, 55.4 percent listed cost reduction or control as the foremost reason they've outsourced their application development tasks; 72 percent of companies that outsource domestically cited quality drivers as their most important considerations. Only 43.9 percent listed concerns about cutting costs.

## Web Site Development and Management

Web hosting was one of the earliest (and ultimately most successful) of outsourced application services, preceding even the short-lived application service provider (ASP) boom of the late 1990's.

The upshot is that there's a thriving market for domestic Web hosting providers. Most of the companies (70.7 percent) that are currently outsourcing some or all of their Web site development and management responsibilities have selected domestic providers. That's right at the overall average (70.2 percent) of companies that plan to outsource domestically.

Similarly, 22.5 percent of companies that currently outsource their Web sites will do so with near-shore or offshore providers.

## Help Desk Support

At first glance, help desk support doesn't seem like an activity that could easily be outsourced. The (often hapless) IT support guy is, after all, the stuff of legend—he's been immortalized in *Dilbert* cartoon strips and lampooned in television situation comedy

sketches—and seems, certainly more than IT and other senior-level executives, to require face-to-face interaction with end users.

In spite of all of this, help desk support is frequently outsourced, and gladly so: 10.6 percent of companies are currently outsourcing some or all of their help desk support responsibilities. Once again, most of these outsourcing contracts (64.1 percent) are awarded to domestic providers, while 28.1 percent are snagged by near-shore or offshore providers.

What's interesting is that a higher-than-usual number of help desk outsourcing contracts (6.4 percent) are going to near-shore providers. This is well above the overall average (2.8 percent) for this segment, and also helps to account for the slight underperformance of the domestic outsourcing segment (which is 6.1 points below average).

Why is help desk support eminently outsource-able? Experts typically cite a pair of reasons: The preponderance of standard desktop applications (the Microsoft Office suite, the Internet Explorer Web browser, etc.), along with the fact that many help desk support calls are related to application performance issues on the network or in the enterprise back-end.

Needless to say, these are both support responsibilities that can with little pain be farmed out to third-party service providers. The typical duration of most help desk support contracts is one year at a cost of less than $1 million.

## Network Operations

A network is, by definition, remotely manageable—although that wasn't always the case. SNMP has been with us for more than a decade now, however, and vendors such as Computer Associates International Inc., Hewlett-Packard Co., and IBM Corp. have marketed network management suites for almost as long. What's more, most modern enterprise

### THE ATTRACTION OF INDIA

The trend to outsource offshore can hardly be surprising: Indian programmers, in particular, have a reputation for skill and competence that is unrivaled.

In the mid- and late-1990's, many prominent U.S. firms—including Microsoft Corp., Motorola Inc., and Oracle Corp.—set up shop in India. In 1994, for example, Motorola's software development center in Bangalore became just the second organization ever to be assessed at Capability Maturity Model (CMM) Level 5 proficiency (NASA was the first). CMM is a maturity assessment methodology developed by Carnegie Mellon University; Level 5 is the high-end benchmark on the CMM maturity scale. Globally, 80 software groups have been assessed at CMM Level 5 proficiency (per 2003 figures); 60 of these—or 75 percent—are located on the Indian sub-continent.

CMM Level 5 stresses process and repeatability, and for that very reason, some believe it's a particularly difficult achievement for U.S. companies—especially if software development isn't their core competency.

"We would be [assessed at] Level 1 or Level 2, because we're starting to introduce some repeatability," says a former programmer with a prominent telecommunications company. "But we probably couldn't ever get above [Level] 2 or 3, just because of disruptive events like layoffs and [employee] turnover. Besides, software [development] isn't our business."

networking devices—from humble department-level switches on up to campus routers—are designed to be managed using either proprietary or third-party tools.

It's not like outsourcing network operations is a new idea, either. Several vendors—including IT services giant Unisys Corp.—started touting managed network services in the mid- to late-1990s.

Currently, nearly one company in ten in our survey (8.9 percent) outsources some or all of its network operations. Of these, the vast majority (80 percent) have selected domestic service providers. That's well above the average (70.2 percent) for this segment.

A considerably smaller number—13.9 percent—have farmed out their network operations to near-shore or offshore providers. That's well below the overall average (24.3 percent) for the combined near-shore and offshore segments. In fact, the number of companies that explicitly identified a preference for offshore service providers (9.2 percent) is 57.2 percent less than the average for this segment.

It's also well below the average (45.4 percent) for application development outsourcing, which is considered one of the most desirable activities to send offshore. This suggests that many of the drivers that account for the popularity of offshore application development efforts—e.g., the world-class skill and expertise of Indian and other non-U.S. programmers—simply aren't operative (or compelling) in the network management space. Just as likely, the overlap between many aspects of network administration and internal security requirements—switches, routers, and other devices all require root-level access for effective administration; other information systems might have to be exposed, as well—are enough to deter many potential offshorers.

## Data Center Operations

Enterprise data centers safeguard an organization's crown jewels—the gigabytes, terabytes, or possibly petabytes of mission-critical data it has created or otherwise accumulated over the years. Why, then, are companies outsourcing the management of their data centers? Probably for the same reasons they've outsourced their application development and security responsibilities: because managing a data center isn't their core competency—and because there's a lot more associated with the management of today's data centers than many companies are prepared to deal with.

Currently, 8.6 percent of companies outsource or plan to outsource some or all of their data center operations. Of these, 68.3 percent have selected domestic service providers, while 23.8 percent are teaming up with near-shore or offshore providers.

Among companies that outsource their data center operations to near-shore or offshore providers, an overwhelming majority (86.7 percent) are enterprises with $500 million or more in annual revenues. Conversely, among companies that outsource their data center operations to domestic providers, 58.1 percent are small and medium enterprises with less than $500 million in annual revenues.

Cost-cutting is a big driver for organizations that outsource their data center operations, but—more importantly—respondents in this segment clearly view data center outsourcing as a means to boost efficiency and overall quality levels, with a combined 68.8 percent citing specific quality drivers like access to specialized data center management expertise, among others.

## Security

Because of the complexity and heterogeneity of operating systems, applications, networks, and other IT resources, an outsourced approach to security actually makes a great deal of sense. Microsoft, for example, released 72 patches for its Windows operating systems and associated applications in 2002, and 50 in 2003. What company wants to be left holding the bag if even one of those patches isn't correctly installed and a security breach occurs?

When you factor in the effect of regulations such as Sarbanes-Oxley (SOX) or HIPAA—which impose penalties (up to and including jail time, in the case of SOX) for organizations that haven't implemented appropriate security safeguards—the idea of managed security services starts to look awfully good.

Overall, 6.2 percent of companies outsource their security responsibilities to third-party providers. Of these, an overwhelming majority—88.4 percent—are contracting with domestic services providers. Another 11.6 percent currently tap, or plan to tap, near-shore or offshore vendors.

Once again, the offshore tally for outsourced security services—7 percent—significantly underperformed the average market share (21.5 percent) for the offshore segment. That's not surprising, however. After all, many organizations have understandable concerns about giving anyone the keys, so to speak, to their IT kingdoms. In the managed security space, especially, it's likely that most companies are simply more comfortable partnering with domestic providers, if only because these providers—and their employees—are subject to U.S. laws.

There are, of course, similar concerns with outsourced services like software development. But many companies address these issues by, for example, segmenting the development and programming (India, China, or Singapore) and testing (domestic) phases of the project. These problems are not so easily mitigated in the managed security space, however, because so many security responsibilities—such as installing firmware updates or operating system patches—currently require root-level access to IT resources.

Nevertheless, some industry watchers believe the market for outsourced security services will explode over the next few years. Consultancy Yankee Group, for example, famously predicted that 90 percent of security will be outsourced by the year 2010. To some extent, this optimism is supported by feedback from respondents: Organizations that outsource their security responsibilities cite drivers such as reducing costs or gaining access to high quality resources (presumably in the form of security expertise) more than anything else.

## Full IT Outsourcing

Believe it or not, some organizations—5.2 percent—have outsourced all of their in-house IT functions. Of these, 79.4 percent have selected domestic services providers. At the same time, 20.6 percent have tapped the services of offshore providers.

What kind of organization can afford to outsource the sum total of its IT responsibilities? Government institutions, for one: 23.5 percent of all lock, stock, and barrel IT outsourcers are local, state, or federal government agencies, and most (75 percent) have partnered with domestic providers.

A surprising number of bleeding-edge outsourcing adopters—82.3 percent—are enterprises with $500 million or more in annual revenues. This seems counter-intuitive, if only because organizations of this size are typically highly geographically dispersed (often with global operations) and dependent on a range of IT resources. These would seem to be the companies that are least able to outsource the entirety of their operations.

What makes an organization like this tick? A mandate to cut costs: 60.5 percent listed cost control or cost reduction as their most important motivations. Next up, a combined 57.8 percent of respondents cited a need to free up internal resources or gain access to IT resources that would otherwise be unavailable internally. Elsewhere, 23.7 percent listed project acceleration as their foremost driver.

# PART 4: CONTRACT SIZE

The nuts and bolts of what our survey respondents' outsourced projects: What's their overall value and duration? We drill down into contracts by project type.

Although a small percentage of organizations have forged—or are otherwise contemplating—mega-deals of $500 million or more, 64 percent of outsourcing expenditures are of the $1,000,000 and under variety.

In fact, nearly one-third (30.1 percent) of companies have signed outsourcing deals worth less than $100,000. Of these, four-fifths (80.3 percent) are SMEs. In the $100,000 and over category, however, the bulk of outsourcing activities (63.3 percent) are performed by large enterprise shops with $500 million or more in annual revenues.

The $100,000 to $500,000 category, where one in five companies value their outsourcing deals, is the next most active, followed by the $500,000 to $1 million category (14 percent).

From this point, of course, sample sizes dwindle and percentages begin rapidly to plunge toward zero: 10.7 percent of respondents have entered into outsourcing agreements worth $1 million to $5 million, for example, while 4.8 percent have notched agreements of between $5 and $10 million. There's a small bump in the $10 million to $50 million dollar range—where 5.3 percent of companies value their outsourcing agreements—but in the $50 million and up range, a combined 5.6 percent of companies have notched outsourcing agreements. That last figure includes the 2.5 percent of companies—AKA, the bleeding edge—that have outsourcing agreements in excess of $500 million.

## Contract Value by Skill, Functional Area

What is the average monetary value for each of the IT responsibilities most frequently outsourced? For all skill areas, the sweet spot is the $100,000 and under space, where nearly one third of companies value their current or prospective outsourcing agreements, while almost one in five projects are in the $100,000 to $500,000 range. Elsewhere, 14 percent of companies value their outsourcing agreements in the $500,000 to $1 million range (see Table 8).

These numbers vary widely across IT skill or functional categories, however. Take application development, for example, where only 21 percent of organizations value their outsourcing contracts at $100,000 or less—and 30.8 percent have agreements in the $100,000 to $500,000 range. In fact, the market for outsourced application development services bucks the average in the $500,000 to $1 million (17.3 percent) bracket, as well, and underperforms at $50 million and up, where only 3.8 percent of respondents value their outsourcing contracts. (This may be because comparatively few companies are entering into long-term contracts with application development services providers. See "Application Development," below, for more details.)

By contrast, 31 percent of organizations that tap managed network services have contracts of $100,000 or less, while 19 percent value their agreements at between $500,000 and $1 million. Nearly 7 percent have notched outsourcing arrangements in excess of $50 million.

## TABLE 8: PROJECT VALUE

What is the value of your most recent outsourcing project?

| | |
|---|---|
| Less than $100,000 | 30.1% |
| $100,000 - $500,000 | 19.9% |
| $500,000 - $1 million | 14.0% |
| $1 million - $5 million | 10.7% |
| $5 million - $10 million | 4.8% |
| $10 million - $50 million | 5.3% |
| $50 million - $1 billion | 4.2% |
| Greater than $1 billion | 1.4% |
| Don't know | 9.6% |

Source: 2004 *Enterprise Strategies* Outsourcing Survey
Results for all respondents answering question

Elsewhere, contracts valued at $1 million and less account for nearly half (49.1 percent) of all current or prospective data center outsourcing agreements. In this segment, nearly a quarter (24.5 percent) of customers have selected outsourcing contracts worth less than $100,000, while 28 percent are opting for contracts valued in excess of $5 million.

Among bleeding-edge adopters that have outsourced their IT operations lock, stock, and barrel, 12.9 percent value these agreements at less than $100,000. The sweet spot, not surprisingly, is in the $50 million and up range, where 32.3 percent of organizations value their current or prospective contracts. The next biggest segment? The $10 million to $50 million space, with 22.6 percent of all activity.

The opposite is the case among companies that have outsourced their help desk support responsibilities: 55.2 percent value these contracts at under $1 million, and just under one-fifth (19 percent) have opted for outsourcing accords worth more than $10 million.

Finally, in the managed security space, a decisive majority (70 percent) of companies value their contracts at $1 million or less. Only 2.5 percent of companies have notched security services contracts worth more than $100 million. By an identical margin, 70 percent of organizations eyeing outsourced Web hosting and development services opt for contracts of $1 million or less. Ten percent value their contracts at $10 million or more.

## Contract Duration by Skill or Functional Area

Few organizations are married to outsourcing, if by "married" one means long-term, multi-million dollar commitments.

Most companies, in fact, opt for outsourcing agreements of less than $100,000 over relatively short periods. Among all companies that outsource, 45.3 percent opt for one-year agreements, 17.2 percent for two, and 11.4 percent for three.

## TABLE 9: CONTRACT DURATION

What is the period covered by your most recent outsourcing project contract?

| | |
|---|---|
| 1 year | 45.3% |
| 2 years | 17.2% |
| 3 years | 11.4% |
| 4 years | 3.1% |
| 5 years | 7.8% |
| 6-10 years | 4.7% |
| More than 10 years | 1.1% |
| Don't know | 9.4% |

Source: 2004 *Enterprise Strategies* Outsourcing Survey
Results for all respondents answering question

Drilling down into the specific skill or functional areas, single-year contracts predominate among companies that have outsourced all of their IT operations, accounting for 44.4 percent of all such accords. In fact, 51.9 percent of companies opt for outsourcing agreements of two years or less; 63 percent arrange for durations of three years or less.

## All IT Functions

Here again, our survey responses vary widely across IT skill categories. Just 37 percent of organizations that outsource all of their IT operations negotiate contracts of five years or more. This is surprising, especially when considered in light of the serious costs companies incur by outsourcing their IT operations in the first place, not to mention the costs associated with switching providers.

There's a further wrinkle, however: All of the outsource-all-IT organizations in the five-year-and-up sample were government institutions, or private companies that post $1 billion or more in annual revenues. At the same time, a majority of companies (71.4 percent) that opt for one- or two-year contract periods also generate revenues in excess of $500 million. So why aren't these shops also locked in to long-term outsourcing contracts?

One explanation concerns the *value* of the contracts in question: Most (78.6 percent) one- and two-year contracts tend to be in the sub-$100,000 to $10 million range, which suggests that these companies, regardless of their size, have comparatively little in the way of IT functions to outsource.

## Network Operations

In the market for managed network services, 38 percent of organizations are opting for contract durations of three years or more, with just 24 percent eyeing agreements of greater than five years. Fully fifty percent of companies—including one-fifth of organizations in the $500 million and up bracket—opt for one-year contracts. This, too, is understandable, in view of the comparative ease—relative, at least, to the outsourcing all of one's IT infrastructure—of farming out network operations.

## Data Center Operations

Understandably, in the market for outsourced data center operations, a higher-than-average number of organizations are emphasizing stability in their outsourcing relationships. Almost half (45 percent) of all companies in this segment are eyeing outsourcing arrangements of three years or more, while 28.6 percent are opting for contracts of five or more years.

## Help Desk Support

The market for outsourced help desk services is another story altogether. In this segment, a clear majority of companies (55.2 percent) have opted for flexibility and low-cost in the form of one or two year contracts worth—in more than two out of three cases (68.2 percent)—$1 million or less.

By an identical margin, 68.2 percent of companies in this segment post annual revenues in excess of $500 million—so limited IT budgets aren't necessarily a controlling factor. More likely, the low average cost and short duration of most contracts in this segment suggest that among companies that have outsourced help desk solutions, cost cutting *is* the issue. Indeed, respondents cited a mandate to reduce or control costs more frequently (72.2 percent) in connection with decisions to outsource help desk support than with any other category.

## Application Development

In application development, that most eminently outsourceable of IT skills, interesting trends abound.

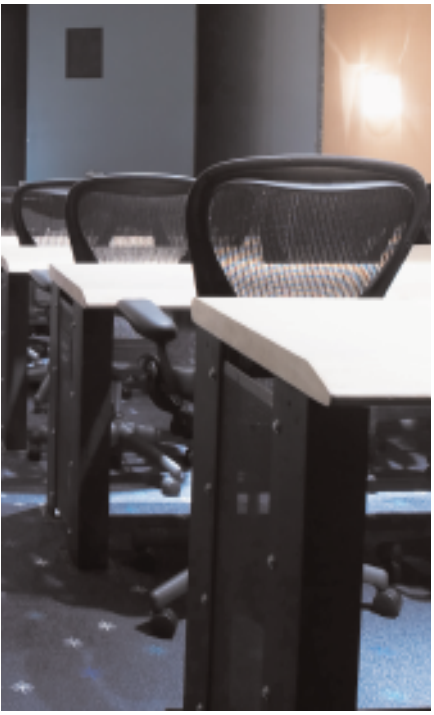
For starters, the majority (61.2 percent) of contracts in this segment are for one year or less, and three-quarters (76.9 percent) are pegged at less than two years. Just one-eighth (11.6 percent) opt for contracts of five or more years. These are staggering numbers, to be sure, but they make more sense when viewed in the context of the primary drivers (lower cost and proven competence) that motivate many application development outsourcers. Companies are, then, outsourcing application development projects on an as-needed basis.

## Security and Web Development

Similarly, 62.5 percent of current and potential security services adopters opt for short-term contracts of one or two years, while another 17.5 percent have negotiated long-term contracts of more than five years. By a similar margin, organizations that outsource their Web hosting and development requirements overwhelmingly opt for one or two year contracts. 15.7 percent select long-term outsourcing arrangements of five years or more.

# PART 5: THE HUMAN COSTS OF OUTSOURCING

The impact of outsourcing on employment is one of the most controversial aspects of the practice. We explore how staff is affected, from the number of employees displaced to job loss by skill and functional area.



Alarmist and not-so-alarmist projections for long-term, outsourcing-related job losses abound, but there's little agreement about just how many IT professionals have thus far been affected by the phenomenon.

Of those responding to the question, over one third (38.1 percent) of companies in our survey eliminated positions or terminated employees—or will do so—as a result of past or present outsourcing moves, This figure alone doesn't tell the whole story, of course, because in many outsourcing deals, employees are reassigned to work for service providers. In still other cases, the people affected by outsourcing moves are contract workers, who are sometimes also reassigned to work for service providers.

Of this total, 7.9 percent were contract workers, while 20.4 percent were a mix of employees and contract workers. Once again, not all of these workers were let go; in fact, 29 percent found work elsewhere within their organizations or were reassigned to work with outsourcing providers.

Feedback from a small sample (141) of respondents provided more information about just how many employees are impacted in the typical outsourcing arrangement. More than half (52.6 percent) of outsourcing deals involve the elimination of between one and 49 IT positions; 12.4 percent the loss of 50 to 99 jobs; and 8.0 percent the termination of 100 to 199 IT workers.

## Job Losses by Skill or Functional Area

Across all skill and functional areas, the IT professionals hardest hit by outsourcing were in shops that (1) outsourced their entire IT operations or (2) outsourced their help desk support efforts.

For example, slightly more than one-third (35.5 percent) of organizations that outsourced their IT operations didn't eliminate jobs. (This is well below the average (59.4 percent for all outsourcers.) Among employees who were displaced by outsourcing pacts, as many as 22.6 percent were able to transfer elsewhere within an organization, or were reassigned to work with outsourcing service providers.

IT professionals were most likely to lose their jobs in outsourcing pacts that involved offshore providers, however. Among organizations that eliminated positions or terminated employees, 36.8 percent partnered with offshore service providers. This is significantly higher than the average combined market share (23.4 percent) for near-shore and offshore providers.

While cost is always an issue, many companies also embrace outsourcing as a means to address quality, efficiency, or business process optimization concerns—except where help desk support is concerned, that is. Slightly more than a third (36.1 percent) of companies

## TABLE 10: DISPLACING STAFF

Have people been displaced or will they be displaced in your most recent sourcing project?

| | |
|---|---|
| Yes, contract workers only | 7.9% |
| Yes, employees and contract workers | 20.4% |
| Yes, employees only | 9.8% |
| No | 55.4% |
| Don't know | 6.5% |

Source: 2004 *Enterprise Strategies* Outsourcing Survey
Results for all respondents answering question

## TABLE 11: NUMBER OF STAFF DISPLACED

If yes to previous question, how many people were or will be displaced in your most recent sourcing project?

| | |
|---|---|
| 1-49 | 52.6% |
| 50-99 | 12.4% |
| 100-199 | 8.0% |
| 200-299 | 2.9% |
| 300 or more | 13.9% |
| Don't know | 10.2% |

Source: 2004 *Enterprise Strategies* Outsourcing Survey
Results for all respondents answering question

retained their help desk support personnel after notching outsourcing agreements. (This is almost 40 percent *below* the average for all companies that outsource.) On a more positive note, one-third of employees displaced by outsourcing pacts managed to find jobs elsewhere within their organizations, or were reassigned to service providers.

Help desk support personnel were also more likely to lose their jobs when outsourcing deals involving offshore providers: 38.5 percent of such accords resulted in job losses for IT pros.

Among companies that outsourced application development tasks, nearly half (48.6 percent) also eliminated jobs. Almost a quarter (24.6 percent) of the employees impacted by these moves transferred elsewhere within their organizations, or were reassigned to work with service providers.

Once again, when offshore deals were on the table, domestic IT jobs were in jeopardy: Among organizations that eliminated positions or terminated employees, 44.3 percent partnered with offshore providers. That's nearly double the combined market share for near-shore and offshore providers.

## TABLE 12: HOW STAFF IS DISPLACED

If you are or will displace staff, how were these people displaced?

| | |
|---|---|
| Most or all were laid off | 35.5% |
| Most or all were hired by service provider | 18.4% |
| Most or all were offered positions elsewhere within the organization | 10.6% |
| A combination of these | 35.5% |

Source: 2004 *Enterprise Strategies* Outsourcing Survey
Results for all respondents answering question

Elsewhere, IT professionals in organizations that outsourced their network operations typically fared much better than their colleagues: 54.3 percent avoided lay-offs, and nearly half of those who were laid-off found work in other precincts (e.g., elsewhere in the organization or with service providers). All told, 73.7 percent managed to retain their jobs.

It's worth noting that even though the market for managed network services was atypically indifferent to the charms of offshore outsourcing (an average of 13.9 percent of companies in this segment opted for offshore partners—compared to a 24.3 percent average in other segments), network professionals were also more likely to lose their jobs when outsourcing deals involved offshore partners. In this case, nearly a third (30.8 percent) of outsourcing arrangements that resulted in employee dislocations also involved offshore servic providers.

For all intents and purposes, security professionals are insulated from the effects of outsourcing: 61.9 percent managed to retain their jobs even when their employers notched security outsourcing agreements. Of those who were laid-off, 68.8 percent were able to transfer elsewhere in their organizations, or were reassigned to work with service providers. All told, 88.1 percent of security professionals managed to hold on to their jobs even after their employers notched outsourcing agreements.

The security market is also a bulwark against the offshore phenomenon: Among organizations that eliminated positions or terminated employees, only a quarter partnered with offshore providers

Finally, nearly two-thirds (63.5 percent) of IT professionals working in Web site development or Web management roles avoided lay-offs when their employers outsourced their IT skill areas. 38.7 percent of those who were let go managed to latch on elsewhere within their organizations, or were reassigned to work with service providers. Offshore vendors were a factor in many of these losses, too: 40.7 percent of outsourcing arrangements that resulted in employee dislocations also involved offshore service providers.

# OUTSOURCING: WHO, WHERE, AND WHY

## The 2004 Enterprise Strategies Outsourcing Survey

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