FORRESTER BIG IDEA

January 12, 2006

Adaptive Sourcing: Outsourcing's New Paradigm

by Julie Giera and Andrew Parker

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Outsourcing Needs A New Business Model

by Julie Giera and Andrew Parker
with Tom Pohlmann and Caroline Hoekendijk

EXECUTIVE SUMMARY

Something is wrong with the outsourcing industry. Despite double-digit growth, providers are facing lower profits, shorter contracts, and unhappy customers. And very few $100 million deals signed today will generate the expected revenues five years into the contract. The fundamental problem? A 30-year-old business model based on inflexibility that doesn't account for the predictable patterns of technology adoption and deployment that every company goes through. The solution? Forrester proposes a new outsourcing business model — Adaptive Sourcing — comprised of flexible contracts, pricing, and service delivery that adapts over time to customer needs and expectations. Adaptive Sourcing will transform the entire outsourcing industry — if vendors have the foresight and courage to adopt it.

TABLE OF CONTENTS

NOTES & RESOURCES

Forrester drew on the following related research documents.

Related Research Documents

"The State Of Vendor Management And Sourcing: Business Technographics® United States"
November 23, 2005, Data Overview

"Europe's IT Infrastructure Outsourcing Matures"
October 31, 2005, Trends

"EDS Is Banking On Transformation Management For Differentiation"
October 12, 2005, Quick Take

"From ASP To Selective Sourcing"
September 13, 2005, Trends

"The Shift To Selective Sourcing Continues"
August 2, 2005, Trends

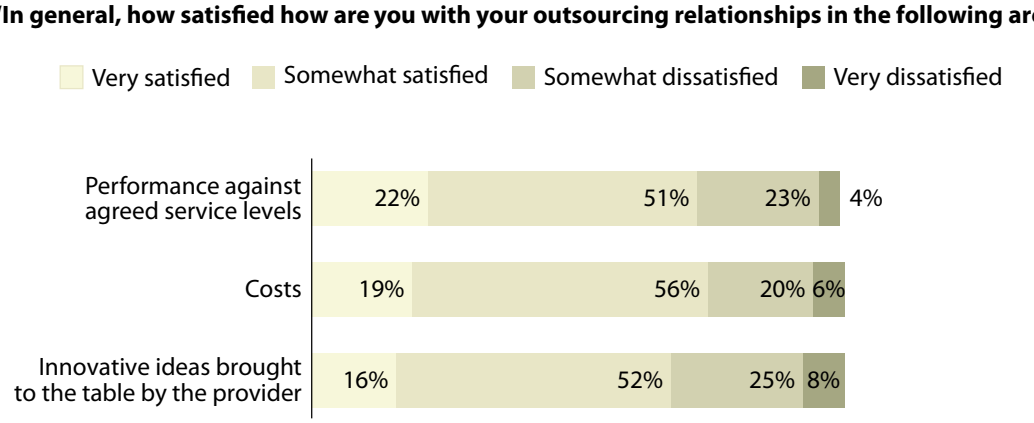
IF OUTSOURCING STAYS THE COURSE, IT WILL FAIL AS A BUSINESS MODEL

Despite growth in the number of deals, outsourcing isn't the healthiest of markets:

- **Deals are underperforming due to contract rigidity.** Forrester's most recent research shows that more than 25% of North American customers are dissatisfied with their outsourcer's ability to hit cost and SLA targets, while 69% of European customers reported failure to meet expectations for innovation (see Figure 1).[1] Failure rates for outsourcing range from 25% to as high as 50%.[2] A review of failed contracts, such as that between Accenture and Sainsbury's, shows that the single biggest reason for failure is lack of flexibility. Outsourcers try to lock customers into long-term deals based on contract terms and pricing that will be out of date six months after the contract is signed.

- **Declining payback for suppliers and buyers offsets growth.** Despite double-digit growth in the number of contracts, the average total contract value (TCV) of outsourcing deals has steadily declined for the past three years (see Figure 2).[3] Outsourcers have to sign more deals at smaller profits to keep pace. Because of their contract, pricing, and services structure, outsourcers don't make real profits until the later years of the contract. Many outsourcers are stuck chasing less profitable deals that will never go to term. Customers are seeing higher costs as well, as the move toward using multiple providers decreases savings — each new outsourcing contract costs customers an average of between 4% and 8% of TCV to manage.[4] And none of this accounts for the fact that each new provider has to learn the customer's environment.

Figure 1 US Outsourcing Clients Express Dissatisfaction With Costs, Service Levels, And Innovation



Base: 214 IT decision-makers at US companies that are outsourcing (percentages may not total 100 because of rounding)

Source: Business Technographics® August 2005 United States Governance Survey

Source: Forrester Research, Inc.

- **Despite signing multiyear deals, customer stability is far from the norm.** This year will smash the 2003 record for the number of existing contracts that are being restructured, according to outsourcing consultancy Technology Partners International (see Figure 3). At the end of Q3, 38% of the total global outsourcing contract value in 2005 was from existing contract restructuring; only 62% was truly new contract value. Restructuring a contract — whether renegotiating pricing or services — means months of disruption and thousands of dollars in costs for customer and provider alike — and it almost always leads to lower revenues for the outsourcing provider.

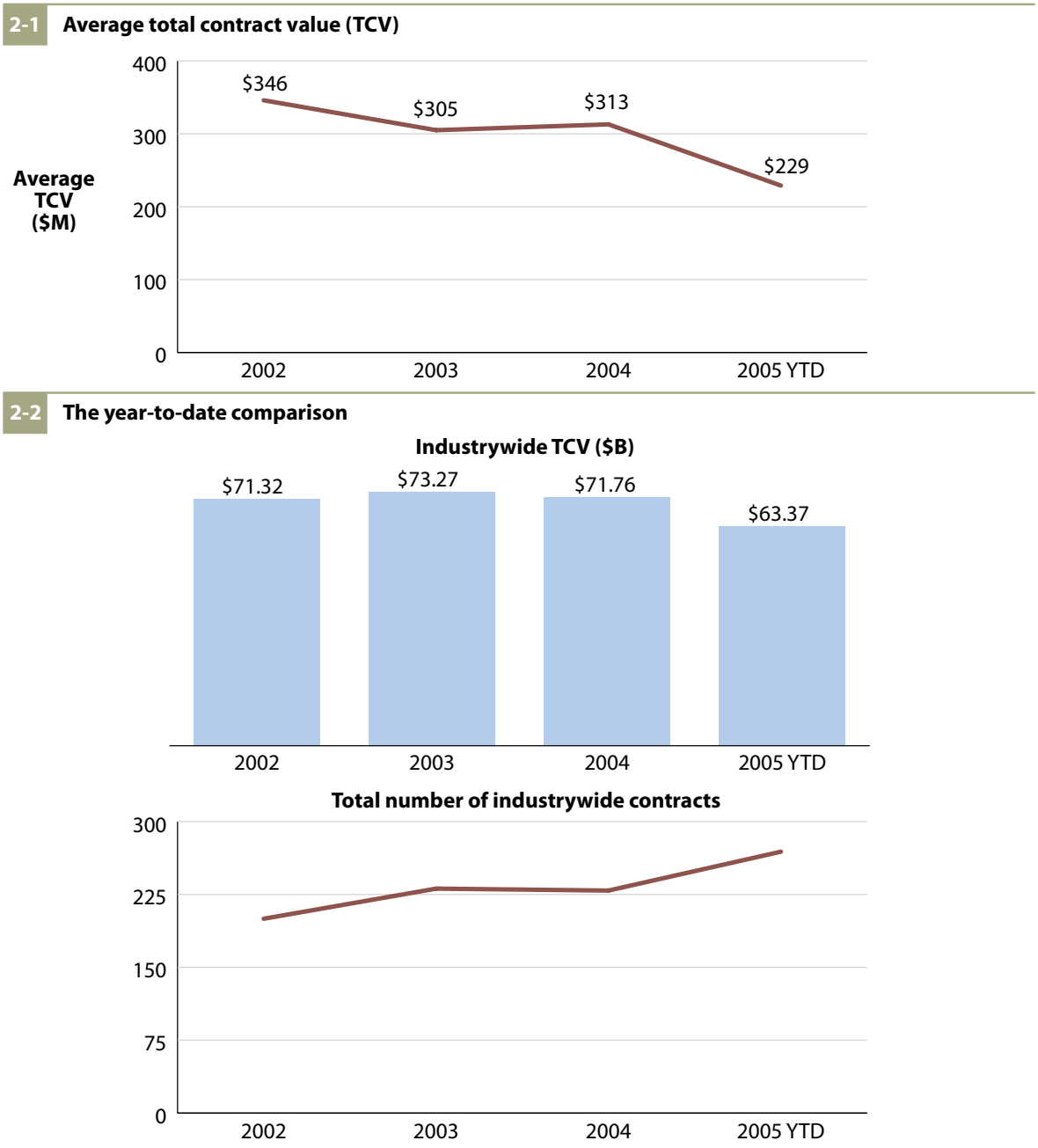
Service Providers Are Stuck

The market statistics show a sorry picture — both providers and their clients suffer from the shortfalls of established business practices. In particular, providers struggle to maintain growth and profitability because they rely too heavily upon:

- **New customer acquisition.** The decline in revenue per deal forces outsourcers to sell more, less profitable deals to stay in business. A sharp increase in sales, general, and administrative (SG&A) expenses across the entire outsourcing industry supports this, despite the numerous restructuring efforts that leading vendors have announced. EDS, for example, has seen its SG&A expenses rise from 7.6% in 2002 to 7.8% in 2003 and to a full 8% last year, despite major restructuring efforts in 2003 and 2004.[5] EDS is not alone. During the same three-year period, IBM eliminated almost 30,000 jobs, yet experienced an 11.4% increase in its base SG&A expense from 2003 to 2004.[6]

- **Stable technologies.** Outsourcers have traditionally based their delivery models on mature technologies: Desktop managed services and outsourcing rack up billions of dollars a year in revenues for outsourcers today, whereas managed services or outsourcing around RFID remain in their infancy. Once a technology becomes pervasive enough in the marketplace, outsourcers sell customers on the fact that they can standardize it, wrap processes and tools around it, and deliver it cheaper — and with higher quality — than an internal IT department can. When client/server technologies were first announced, consulting boutiques like Cambridge Technology Partners dominated the market. Big outsourcers like IBM and EDS didn't begin offering outsourcing and consulting around these technologies until three or four years later. During the early stages of the Internet boom, boutiques like Scient and Viant got the lion's share of revenues, and it wasn't until later that outsourcers began to offer their customers packaged Web design and implementation services.

Figure 2 The Average Total Contract Value Is Declining

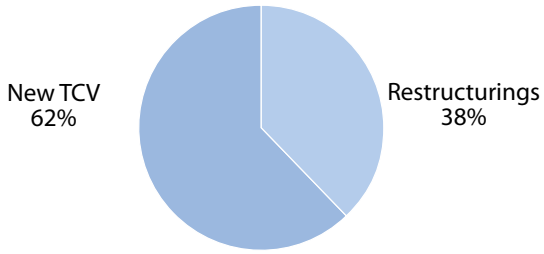


Base: global industrywide outsourcing contracts with a total contract value greater than $50 million
Source: Technology Partners International

Source: Forrester Research, Inc.

Figure 3 Contract Restructurings Set A New Record In 2005

2005 YTD outsourcing mega-deals: restructurings versus new total contract value (TCV)



Base: 8 global mega-deals with a contract value greater than $1 billion

Source: Technology Partners International

Source: Forrester Research, Inc.

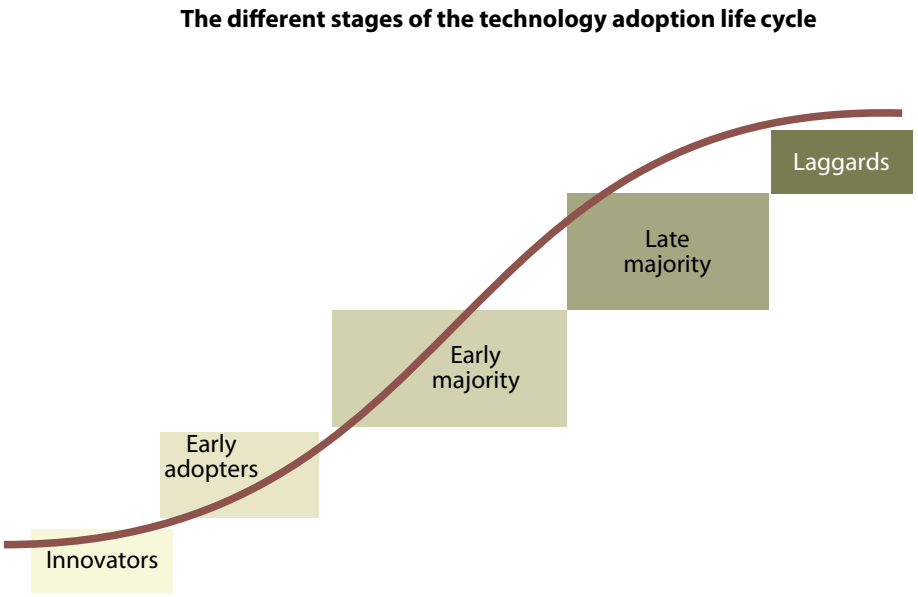
- **Selling to the late majority.** Technology gets introduced into the market in predictable waves, from innovators and early adopters to laggards that wait six or seven years before converting (see Figure 4). In the earliest stages, innovator or early-adopter companies turn to boutique consultancies to fulfill their needs. That's due to two factors: Outsourcers lack standard offerings at this stage of technology adoption, and customers aren't interested in signing multiyear deals. Rather, customers at this stage are experimenting with new technologies. They want: a flexible, innovative partner; a short-term, project-oriented contract that lasts months — not years; and a time-and-materials payment structure. To date, that has meant a specialty boutique consultancy or systems integrator — not an outsourcer.

  When technology reaches critical mass, outsourcers step in with their standardized offerings and service-level guarantees, wanting to sign customers to long-term deals. At this point in the cycle, outsourcers are losing deals to low-cost commodity outsourcers like Dell and the Indian offshore firms that take mature technologies, drive out labor costs, and offer customers a much better deal. The outsourcers are squeezed; they're losing the early-adopting customers to boutiques and the cost-conscious customers to the commodity vendors (see Figure 5). They're stuck in the middle, kidding themselves and everybody else that the seven-year deal they sign today will really go the full seven years at the projected profit margins.

Customers Bear The Brunt Of A Broken Business Model

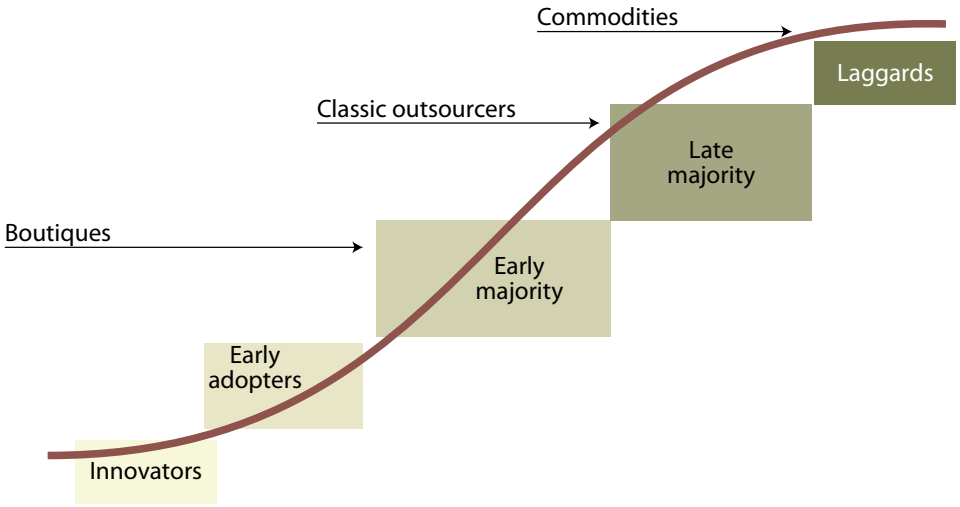
Outsourcing customers also acutely feel the impact of the existing business model. The time, effort, and costs associated with creating and issuing an RFP, selecting a provider, negotiating a contract, and dealing with ongoing benchmark clauses and contract changes can be onerous.

Figure 4 Technology Maturation And Adoption Rates



Source: Forrester Research, Inc.

Figure 5 Classic Outsourcers Lose Customers To Competitors



Source: Forrester Research, Inc.

- **Changing an outsourcing relationship is expensive.** Once they've signed an outsourcing relationship under the existing business model, customers usually engage in periodic benchmarks to ensure that the vendor is appropriately pricing its services. Benchmarking specialists like Compass can charge anywhere from $50,000 to $250,000 for these projects, which typically last six to eight weeks. After they know the benchmarking results, customer and outsourcing vendor usually enter into renegotiation to adjust pricing and service levels. Again, internal resources and legal counsel get involved. Aside from benchmarking, normal changes in the customer's business often require contract changes or addendums — which also involve legal counsel and internal resources. And these costs apply to every outsourcing supplier in the organization. If an organization has engaged in a multisourcing strategy with five different suppliers, it costs time, money, and resources to establish and maintain each one.

- **Business disruption shouldn't be underestimated.** For most companies, the mere mention of outsourcing is enough to hinder productivity, both in the IT department and in the business units. Nervous staff delay in-process projects, managers become more cautious about making decisions, and the rumor mill spins into overdrive as speculation becomes rife. The entire procurement, negotiation, and transition process will affect the business units for months at significant cost to the organization.

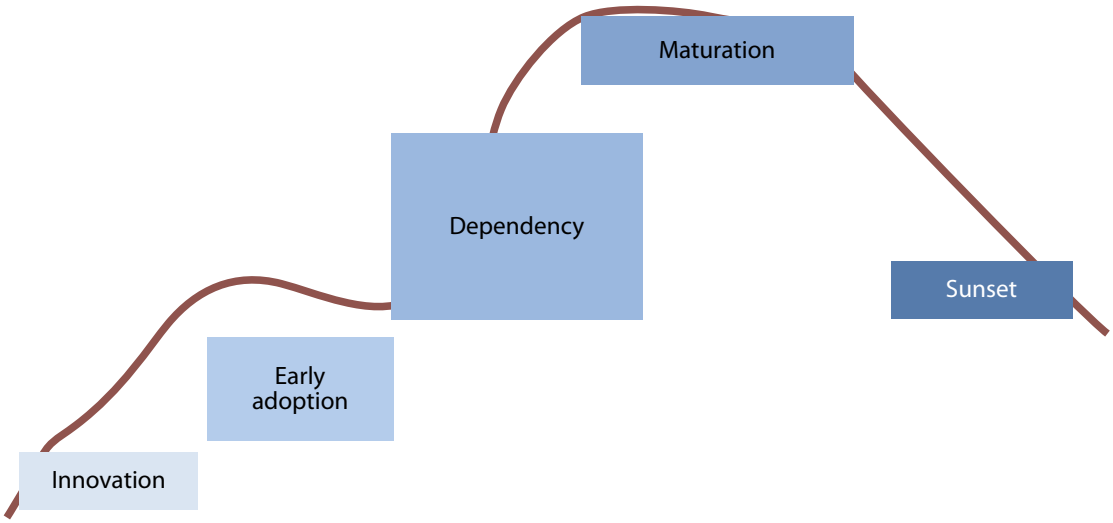
ADAPTIVE SOURCING IS THE FUTURE

Outsourcing can be a much more powerful and effective tool if vendors accommodate, in a single outsourcing relationship, the differing needs of their customers throughout the life cycle of technology adoption. By recognizing these transitions and *proactively* adjusting contracts to align with the needs at a specific point in time, outsourcers can retain business, forestall benchmarking and renegotiation, and improve profitability. Customers, on the other hand, will secure more strategic relationships with their providers, experience lower overall costs, and finally see the value and flexibility that they so desperately need. Tinkering with the old outsourcing model won't accomplish this. Vendor and customer alike need to adopt a new business model — one that Forrester calls Adaptive Sourcing. Key components of Adaptive Sourcing include:

- **Service portfolios that align with technology adoption curves.** Technology gets introduced into the marketplace and absorbed by customers in predictable waves, from innovators to early adopters to laggards.[7] Inside organizations, customers also implement technologies in predictable patterns — from experimentation, to building their business with the technology, to finally sun-setting the technology once it is no longer viable for the organization (see Figure 6). Adaptive Sourcing means that outsourcers will offer service portfolios and delivery structures that align with these adoption curves. This will help them retain customers throughout the technology life cycle and reduce their overdependence on new business.

Figure 6 Customer Expectations Shift With Adoption Cycles

6-1 Customer technology adoption cycles



6-2 Key outsourcing criteria for each phase of the customer technology adoption life cycle

Innovation	Flexibility, experimentation, technical prowess and leadership
Early adoption	Implementation skill, speed, training, collaboration
Saturation/dependency	SLAs, process, scale, standardization, reliability, enhancement
Maturation	Low costs, SLAs, predictability, maintenance/enhancement
Sunset	Risk avoidance, SLAs, support, migration and conversion

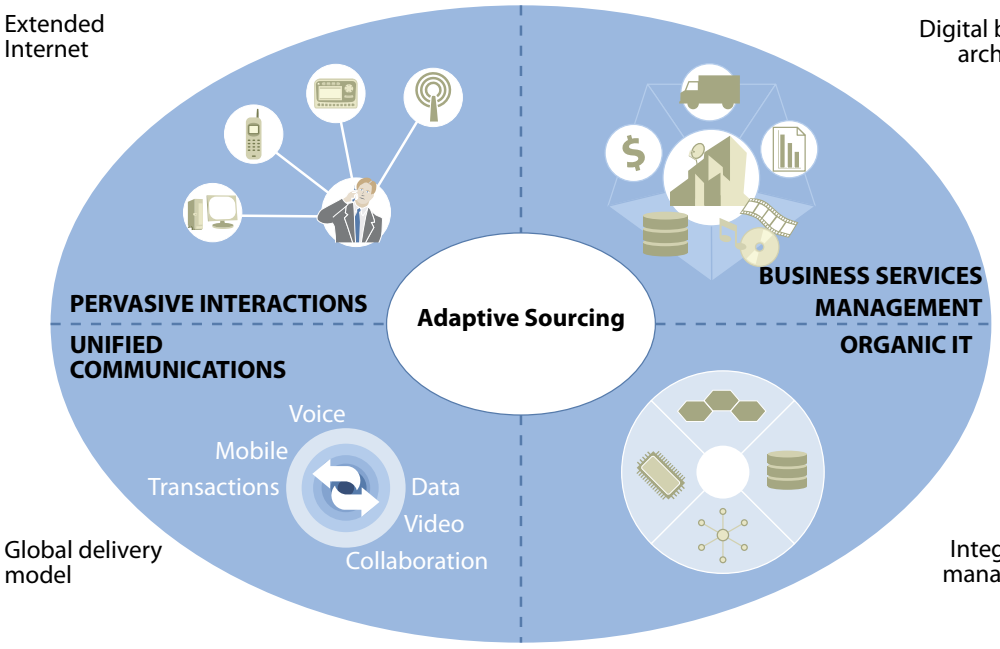
Source: Forrester Research, Inc.

- **Contracts, pricing, and SLAs that flex to match customer needs.** At each stage of customer adoption of technology, organizations have differing expectations or value that they expect from their services providers. When experimenting with a new technology, customers value flexibility, innovation, technical prowess, and a vendor that can help them envision how the technology might affect their business. Similarly, when a customer has deployed the technology and the business depends on it, value expectations change yet again. The value proposition turns to consistency and reliability, high service levels, and predictable costs. Therefore, outsourcing contracts will have a standard framework, within which the services, SLAs, pricing, and terms/conditions will flex depending on the customer's technology adoption phase.

- **Industry-specific wrappers.** Technology adoption life cycles, both market- and customer-facing, will vary by industry depending on the technology. For example, manufacturers and distributors are likely to adopt RFID technology much sooner than financial services organizations are. By anticipating the adoption curves of various industries, outsourcers can prepare product portfolios, pricing, and SLA structures adapted to the needs of those companies at any point in their adoption life cycle.

- **An industrialized delivery platform — finally.** Starting next year, there will be a convergence of new technologies that will allow outsourcers to effectively deliver the Adaptive Sourcing business model (see Figure 7). Integrated IT management (IIM) tools will allow outsourcers to anticipate, forecast, and proactively respond when customers transition to a new phase of technology adoption.[8] Vendors like IBM are already using some of the underlying pieces of IIM, such as project portfolio management techniques, to maximize employee allocation and usage. Keane Associates has used IIM dashboards for several years to link its services to business outcomes. Digital business architecture (DBA) will lay the foundation for technology flexibility that will allow outsourcers to dynamically change the delivery model of their services as customer needs require.[9] Network convergence finally creates the pipelines through which global service delivery can truly occur, with services delivered from anywhere to anyone or anything across multiple delivery channels.[10] For instance, EDS linked a physical device (the onboard computer in a GM car) with its satellite network to create GM's OnStar service.

Figure 7 Technology Convergence Facilitates Adaptive Sourcing



Source: Forrester Research, Inc.

Adaptive Sourcing In Action

Let's look at an example of how Adaptive Sourcing might work. A large trucking company facing increased fuel prices wants to cut costs and maximize the time that drivers spend doing deliveries and pick-ups. RFID and GPS technology seem, on the surface, to be an answer. At this stage, the customer is looking to pilot the technology and is seeking technical expertise and guidance, preferably from a vendor that knows the trucking industry. Because RFID technology is in the early stages of market adoption, the Adaptive Sourcing outsourcer has a package of services, pricing, and SLA structures already tailored for transport industry customers in the innovation stage of adopting RFID. The outsourcer offers its customer a short-term, project-oriented agreement with time-and-materials pricing. There are few, if any, service-level guarantees, and the customer can cancel the project at any time without penalty (see Figure 8).

As the trucking company realizes success with RFID and GPS technology pilots, their needs change again. Now that the trucking company has found it can trim its fuel costs by 20%, the CEO wants to roll out the technology to every truck in the fleet. An outsourcer using Adaptive Sourcing has anticipated the success of the pilot and has a prepared set of services geared toward rapid rollout, the achievement of implementation milestones, fixed-bid payment structures, and perhaps even a bit of gain sharing, where both customer and vendor share in a portion of the fuel savings. Speed determines the success of the rollout, as does perhaps business outcome but not cost. In fact, most customers would pay a slight premium at this stage of adoption.

Figure 8 The Adaptive Sourcing Business Model

Stage	Contract Terms	Pricing	Service Levels
Innovation	Short project, no cancellation penalty, fluid	Time and materials	Few, if any
Early Adoption	Implementation and rollout project, flexible contract	Fixed bid, pay at milestones, emphasis on speed	Tied to dates, deliverables
Dependence	Multiyear maintenance, enhancement, and support services	Predictable pricing; either per devices, per user, or fixed price per month	Robust SLAs, reliability, quality, and enhancement
Maturity	Standardized, leveraged services, utility or offshore delivery models, maintenance and support	Low-cost, usage-based pricing	Standard SLAs
Sunset	Support, risk avoidance services, multiyear with transition	Price based on need for specialists to support, maintain	Strong support and problem solution

Source: Forrester Research, Inc.

Eventually, the trucking company will build entire business processes around the RFID and GPS technology in its trucks and become dependent on the technology. The technology no longer gives this customer a competitive advantage, but has become part of doing business. SLAs involving uptime and response time are now appropriate, and the ability to consistently forecast costs to manage and support the technology becomes key. Contracts will be based on a fixed, monthly cost per truck, or perhaps per transaction. SLAs with penalties for nonperformance become the basis of service delivery. Because of organizational dependence on the technology, support becomes paramount, as does problem identification and resolution.

Several years from now, RFID and GPS will have become pervasive and in the latter stages of their life cycle (the maturity stage). These technologies are aging and have become much more common across the marketplace. Their value to this customer has transitioned yet again. Lowering the cost of these services while maintaining reliability is now paramount. The outsourcer will have a prepared low-cost offering (perhaps involving offshore delivery or a lower-cost partner) and proactively offers this to the customer. Pricing is based on standardized services and service levels, perhaps delivered via a utility-based model.

Finally, when new technology replaces RFID and GPS, the trucking company will be concerned about mitigating risk. The old technology can't break while they transition to a new, replacement technology, and this may take several years. In Adaptive Sourcing, the outsourcer will recognize that customer value has again shifted, from low costs to risk mitigation — much like the situation companies are facing today with their old COBOL programs. There will be fewer and fewer people who can support the old technology, and the costs to maintain the environment will continue to rise. The customer may pay its outsourcer a premium just to ensure that it isn't affected while the transition to a new innovation cycle begins again. The outsourcer will craft a contract based on guaranteed support, minimum SLAs, virtually no enhancement, and maintenance services limited to audit and compliance with regulatory or security concerns.

Looking beyond the RFID example we've been using, our hypothetical trucking company will have an Adaptive Sourcing environment comprised of many different technologies, delivery mechanisms, and pricing schemas, all within one common contractual framework. For example, the finance department's old COBOL system might be at the sunset stage of its life cycle. The outsourcer will manage this system with minimal resources, an emphasis on risk mitigation, and SLAs focused on keeping the system alive and breathing. On the other hand, the desktop management services that the outsourcer provides have hit the maturity stage; reducing costs has thus become paramount. The outsourcer will deliver these services, perhaps via a low-cost partner or subcontractor, based on a standardized desktop platform, a low monthly cost per desktop, and service levels in line with the market. Our trucking company will have one master agreement with the outsourcer under which the services, delivery method, pricing, and SLAs will all flex for each service delivered, depending upon where on the adoption curve the various technologies might be.

Adaptive Sourcing Provides A Model For Business-Led Outsourcing, Too

Adaptive Sourcing offers a new paradigm for IT outsourcing, one that firmly ties the value of services delivered to the evolution of technology at the client enterprise. But some execs will ask how this IT-led view of outsourcing links with business outcomes, such as transaction throughput or process improvement. And providers like IBM, Accenture, and EDS — which tout business-led outsourcing concepts like transformational outsourcing or business performance transformation services — will ask why their concepts of continuous improvement focused on business metrics don't serve equally well as, if not better than, Adaptive Sourcing. Adaptive Sourcing trumps established business-focused sourcing strategies because:

- **Business transformation outsourcing (BTO) offers only focused innovation.** A large BTO deal, such as Accenture's purchase-to-payment relationship with Deutsche Bank, relies on business metrics for success. So much the better for that, of course — the client looks precisely for process improvement and business efficiency as the desired outcome. But the structure of such a contract too often relies on defining a precise technology end state that the service provider can stabilize to offer continuing low-cost operation. Innovation, so far as it exists, is limited to that stated outcome. The structure of the outsourcing deal isn't based on predictable cycles of maturity and associated changes in outsourcing delivery and pricing mechanisms: It's really just the same old outsourcing deal in new packaging — like putting lipstick on a pig. The business model is still based on one "build" phase (transformation) and years of running the resulting environment at as high a price as possible.

- **Business-led outsourcing lacks transparency over costs and margins.** Based on Forrester's observations of many large BPO, BTO, and similar business-outcome-driven deals, service providers frequently employ these types of contracts to avoid being driven into a commoditized area of IT service delivery where their profit margins will be exposed to the client and brutally driven down by market competition and benchmarking. By building a raft of consulting, apps development, solution deployment, and operational management into one complex contract — typical in a BTO deal — the service provider aims to hide its overall margins and give itself more flexibility to realize greater profits over the term of the deal.

- **Adaptive Sourcing's IT improvements feed into business effectiveness.** The performance improvements and IT deployment efficiencies gained through Adaptive Sourcing feed straight into business effectiveness for the end user. A bank that chooses to use an Adaptive Sourcing approach to support a new set of analytical tools in its collections department may cut the deployment time by many weeks relative to an in-house project or a multivendor strategy.[11] That's because the in-house team has a learning curve with the new analytical tools, and the specialty multisource provider has a learning curve related to the customer's particular business environment. An established outsourcer that knows and understands both the new technology and the customer environment can cut these learning curves substantially. The end result is less business disruption and faster payback on the project.

- **Adaptive Sourcing addresses business process life cycles, too.** The technology life-cycle analysis that makes Adaptive Sourcing effective and valuable in IT outsourcing relationships applies equally in the business domain, albeit over longer life cycles. Companies operate business processes that are, in many cases, linked to the life of a given product, adapting the processes as the products evolve. By applying the Adaptive Sourcing approach, business process outsourcers can create the same flexible framework for BPO delivery that we've already mapped out for IT outsourcing. This approach allows for the deployment of flexible, prototype technology solutions in the early stages of the process deployment, building up to more stable, high-throughput systems as the process scales up to full production, and then moving on to commodity, low-cost platforms as the process reaches or goes beyond maturity.

THE ONUS IS ON SERVICE PROVIDERS TO GET TO ADAPTIVE SOURCING

Not all outsourcing deals or contracts will be appropriate for this model. There are, and will continue to be, situations where a short-term contract for commodity services or boutique consulting is perfectly appropriate. But for most customers that want a service provider relationship and not just a transaction, Adaptive Sourcing is the way to go. Getting there requires the following, with leadership primarily from the outsourcing service providers:

- **A phased approach.** Moving to this new model is less a wholesale transformation than it is a phased approach because of the immediate impact on profit margins, cultural behavior, sales, and support. To minimize risk for vendor and customer alike, outsourcers should begin their journey to Adaptive Sourcing with existing customers, where the parties have already established a measure of trust. Vertical industries, such as retail and healthcare, are experiencing some of the most profound technical changes with RFID technologies, for example, so they may make attractive targets for Adaptive Sourcing initiatives, as well. Entire sets of service lines are also good candidates. For instance, desktop and help desk management services have long been in the commodity stage of technology adoption, yet many outsourcers attempt to hold their customers hostage with high-priced services for as long as possible. For example, if an outsourcer like IBM can no longer offer its customers competitive pricing for desktop management, it should shift the delivery of those services to a less expensive partner like Unisys or Getronics and pass on a lower price to the customer.

- **Account teams trained to recognize transitions.** Outsourcers will need to reorganize and retrain their sales and account management teams to recognize when a customer is transitioning from one phase of technology adoption to the next (see Figure 9). Proactive selling, rather than defensive margin protection, is the key to a successful Adaptive Sourcing model. Account teams must be willing to cannibalize their short-term profits in exchange for retaining the long-term customer relationship — and must have the appropriate incentives to do so.

Figure 9 Identifying Transitions For Adaptive Sourcing

Innovation

- Will business processes change as a result of this technology?
- Are there still questions about the long-term results of this technology introduction?
- Do you see a need for scalability or flexibility over time with this technology?
- Is this technology new to the organization? Does the organization have knowledge/skill with this technology?

Early adoption

- Are more users going to be using this technology in the near future?
- Is the technology growing in importance to your business?
- Are you reconsidering your service levels? Are you planning to increase them?
- Are backup and recovery plans growing in importance?
- Is there now a significant amount of revenue passing through these systems?
- Are the business units beginning to (or will they) rely on this technology to meet their business-related goals?

Saturation/dependency

- Is this a "bet the business" application?
- Will this change the way that consumers in your marketplace behave?
- Will this fundamentally change the way the business operates internally?
- Will this change the way that the investment community views your organization?
- Does this technology have awareness at the highest management and executive board levels?

Maturation

- Do you really need the service levels you currently have in place?
- Is it possible to reduce the cost of running these systems, even at the expense of performance?
- Do you consider these technologies non-differentiated
- Has the maintenance cycle for these systems stretched out?
- In your disaster recovery plans, are these systems at the bottom of your list of systems to recover?
- Do you have your less senior staff working on these systems?
- If we paid you cash to take these assets off your hands, would you be happy?

Sunset

- Is this system/technology more than five years old?
- Is there a viable replacement to this technology?
- Is it becoming more expensive or harder to get support for this technology?
- Is the technology "maintainable"? Are there commercially available support options readily available?
- Is the vendor continuing to provide enhancements and/or maintenance releases?
- Should it be "sunset" to free up resources for higher return on investment choices?

Source: Forrester Research, Inc.

- **Flexible account management structures.** Right now, most outsourcers bring an entire contingent of personnel to manage an outsourcing relationship, regardless of whether this is appropriate for the customer's stage of technology adoption. For example, in a recently signed five-year, $200 million outsourcing contract in Europe, IBM assigned a total of seven people whose sole responsibility is account management. This isn't the delivery team, but account managers, clerical staff, finance, and process experts — the "overhead" of outsourcing. In the earliest stages — such as innovation and early adoption — there isn't a need for hordes of on-site management overhead. Similarly, when a customer begins to build its entire organization

around a technology, the outsourcers need to provide a different composition of account management functions. Outsourcers must be able to adjust the composition of their account management structures, the location of these functions, and the depth of skill required.

- **Providers and investors willing to adjust their forecasts.** Accounting and revenue recognition will have to change to more accurately account for the ups and downs of revenue and profit that will occur over the lifetime of a customer relationship. Forrester believes that these cycles are predictable and can therefore be planned. Many of today's forecasts are inherently wrong anyway, based on the fallacy that the contract signed today will continue to generate the same revenue and profit stream over its lifetime — especially given the numbers of customers entering into renegotiation. Although outsourcers know that profits from existing business will change over time, most don't forecast that way. Many providers assume that they'll be able to sell the customer new projects or new services over the course of relationship and that these will make up for the revenue deterioration that's occurring over the life of the deal. But as we've seen, net new revenue isn't always keeping pace with the deterioration that's occurring on the rest of the deal.

- **Vendors more active in the business plans of their clients.** Communication between vendor and customer must improve in an Adaptive Sourcing model. The often overused term "partnership" really does apply here. For an outsourcer to react appropriately, with the right services — at the right price — at the right time, customers must be willing to involve the service providers more actively in business planning. This does not mean giving away strategic plans to a third party; it does mean more focused communication about the company's strategy and direction.

- **Vendor management teams geared for collaboration, not confrontation.** The structure of the vendor management teams that have sprung up within customer organizations may also have to change. Vendor management teams get more staff and bigger budgets if the customer is constantly renegotiating existing deals and seeking "best-of-breed" suppliers. Adaptive Sourcing is based on fewer suppliers, but better relationships — and less "churn" around contract terms, conditions, and pricing. Members of the vendor management team will need to be more adept at managing the multiple delivery models, pricing structures, and business metrics contained within a vendor relationship. However, if vendor management teams understand and adopt an Adaptive Sourcing model themselves, they should be able to proactively forecast their future needs. This makes for a much more strategic approach to sourcing and a more strategic role for the vendor management function.

- **A more inventive use of alliance partners.** Vendor partnership models will also have to change if outsourcers are to maximize their ability to deliver adaptive services. It makes little sense, for example, for every outsourcer to build boutique consulting practices or commodity practices that can address the needs of customers throughout all stages of technology adoption.

Rather, outsourcers should establish a contractual framework under which they are the prime contractor and can plug the appropriate subcontractor in and out of the relationship as customer needs (and the technology adoption life cycle) demand. This would be pre-established in each offerings portfolio; when a customer transitions from one phase of technology adoption to the next, the outsourcer would have already established the service offering, the pricing model, and the subcontractor most adept at delivering the services for this particular phase.

WHAT IT MEANS

OUTSOURCING WILL STAGE A RESURGENCE BUILT ON CLIENT SATISFACTION

Adaptive Sourcing will go a long way toward fixing some of the ailments of the outsourcing industry.

- **Traditional outsourcers with broad services portfolios will keep more customers.** There will still be demand for boutiques, but customers won't be forced into early renegotiation or multiple suppliers because the incumbent outsourcer won't or can't meet its needs. Low-cost firms like the Indian outsourcers, for example, will have to broaden their offerings and adopt Adaptive Sourcing if they are to be anything more than one-trick ponies with their lower labor rates. Service consortia and partnering will be the order of the day: We expect the offshore outsourcers, boutiques, and commodity vendors like Dell to establish wider-reaching partnerships with classic providers than ever before.
- **BPO and ITO will grow faster.** One of the primary impediments to outsourcing remains loss of flexibility for the client. Adaptive Sourcing will solve some of those issues, leading to an increase in technology and business process outsourcing. Outsourcers and customers will find less disruption to their business due to fewer renegotiations, which will lessen costs and improve value for both parties. And customer satisfaction should rise — leading to more cooperative, open (and therefore more enduring) relationships between providers and clients.
- **Asset ownership transitions will slow, and financial models will change.** Classic outsourcers like CSC, EDS, IBM, and Capgemini own billions of dollars of computer assets. It is much more difficult for these vendors to recognize and react to changes in customer adoption cycles — to do so puts the value of these assets at risk. In fact, the classic outsourcers are motivated *not* to transition a customer from older technologies to leading-edge ones. For customers to truly get flexible services and pricing from their outsourcers, asset ownership has to become a much less frequent occurrence in outsourcing deals than is the case today.[12]
- **More technology alliances will come to the fore in outsourcing.** Recent outsourcing deals like the multiple contracts for the UK's National Health Service signed in 2004 showed how outsourcing firms like CSC and Fujitsu could meet client needs by linking up with specialist

technology providers like Kodak and BT. Adaptive Sourcing will accelerate this trend further, as outsourcing providers bring technology firms into stronger relationships to allow them to show clients more responsiveness to technology life-cycle transitions. Expect to see EDS make its Agility Alliance the core of its move toward Adaptive Sourcing, and look for other large outsourcing specialists like Atos Origin and CGI to follow EDS's lead.

- **Outsourcing success can finally be based on business outcomes, not technical SLAs.** By aligning delivery, pricing, contract terms, and service levels directly with customer needs, outsourcers will no longer deliver services based solely on technical metrics like system availability and online response time. Rather, they will use the real value the customer is expecting at each stage of technology adoption to measure success. For example, in the innovation stage, technical talent and flexibility are important; in early adoption, speed of implementation is key; and at maturity, cost is king. By tying services directly to business outcome and business value, both parties will have much more successful — and measurable — relationships.

ENDNOTES

[1] Forrester interviewed 18 large European companies to better understand how they regard their outsourcing relationships. More than two-thirds of these companies said that the outsourcing provider in their largest outsourcing relationship either consistently or occasionally fails to deliver the innovation they require. See the December 15, 2005, Best Practices "The IT Outsourcing Satisfaction Paradox."

[2] Failure of outsourcing is defined in this context as outsourcing agreements that are either cancelled, not renewed, or are renegotiated due to dissatisfaction with price, service, or quality. Deloitte Consulting's April 2005 outsourcing study states that 70% of the participants were dissatisfied with their current outsourcing contracts and 83% had renegotiated their contracts in response to changes in prices, business/technology shifts, or regulatory requirements. Dun and Bradstreet's 2002 outsourcing study claims that 20% of outsourcing contracts fail in two years and 50% in five years. And Diamond Cluster's 2003 analysis indicated that 78% of respondents had to terminate their contracts early due to poor service, cost increases, or changes in direction. Visit www.deloitte.com/dtt/cda/doc/ content/us_outsourcing_callingachange.pdf and www.dnb.com.au/receivables/barometer_2002.asp and www.diamondcluster.com/Go/OutsourcingStudy/GlobalIT-OutsourcingStudy.pdf for more information.

[3] Outsourcing industry consultants Technology Partners International created the TPI Index, a quarterly report that has tracked the total contract value of IT outsourcing deals since 2002. TCV has declined significantly in the past three years, based on the most recent TPI report of October 17, 2005. Visit www.tpi.net for more information.

[4] Forrester highlights not only the move toward using multiple suppliers, but also the impact of benchmarking on outsourcers' profits. During Q1, Forrester found only eight North American outsourcing contracts awarded that were larger than $15 million: Of those eight, only one deal was considered a "mega-deal" with TCV greater than $1 billion. The absence of more mega-deals contrasts sharply with years past,

reinforcing the trend toward smaller, shorter outsourcing contracts. See the August 2, 2005, Trends "The Shift To Selective Sourcing Continues." In a 2003 Compass report, outsourcing expert Professor Leslie Willcox states that the average cost to manage an outsourcing contract is 4% to 8% of total contract value; he also says that offshore outsourcing contracts can cost upward of 15% of TCV for less experienced customers. These management costs were based on a joint outsourcing study with the Warwick Business School (www.wbs.ac.uk) that included more than 300 outsourcing relationships. Source: Leslie Willcox and Geraldine Fox, "Adjusting Outsourcing Relationships to a New Economic Reality," 2003. Visit www.compassmc.com/destinations/our_views/views/threeyearitch.htm for more details.

[5] EDS's 2004 annual report discusses an increase in SG&A expenses, despite restructuring its management overhead during the prior three years. The report goes on to note that while it's costing more to sell new deals, the TCV of deals is declining — thus forcing EDS to sell more new business to keep the same profit margins. EDS isn't alone: The annual reports of IBM, CSC, and Capgemini for the same three-year period show similar trends.

[6] In the past three years, IBM has announced two major layoffs and several rounds of smaller downsizing. The major job reductions were in May 2002 (15,600) and May 2005 (13,000). Visit www.ibm.com/annualreport/2004/ for a discussion of SG&A expense increases.

[7] Forrester has previously discussed technology introduction and digestion cycles. We have highlighted these predictable patterns of technology absorption in the marketplace over the past 30 years and forecast the next big shift in new technology adoption cycles. See the June 24, 2005, Trends "The Seeds Of The Next Big Thing."

[8] Integrated IT management is the maturation and convergence of the tools and dashboards that IT managers must have to effectively oversee their organizations and deploy appropriate resources. This is a necessary component to Adaptive Sourcing if outsourcers are to recognize when customers are transitioning from one technology adoption phase to another. See the February 2, 2005, Forrester Big Idea "Integrated IT Management Drives Efficiency."

[9] Digital business architecture will establish the architectural frameworks that allow outsourcers the flexibility they need to truly deliver Adaptive Sourcing. Without it, outsourcers will be left managing environments that are resistant and expensive to change. See the November 7, 2005, Forrester Big Idea "Digital Business Architecture: IT Foundation For Business Flexibility."

[10] For example, the extended Internet (the connection of the physical world to the digital world) is wholly reliant on network convergence and the emergence of standards that have only just begun to mature. For outsourcers to deliver anywhere, anytime services that rapidly respond to changing customer needs, network architectures and technologies have to be robust and flexible enough to support these delivery models. The lack of network convergence in years past has been one of the primary impediments to Adaptive Sourcing business models.

[11] The learning curve associated with either new technology or a new service provider significantly impacts overall ROI. In fact, this impact is so substantial as to heavily favor the use of outside consultants, even though the hourly rate charged by services providers appears to be much higher than the cost of an internal

IT resource. See the May 21, 2001, Planning Assumption "Justifying IT Investments: The Case For Keeping Consultants."

[12] The offshore outsourcers have been successful only partly due to low-cost labor. In fact, the bigger reason for their fat profit margins has to do with their absolute avoidance of asset ownership in the outsourcing deals they sign. For the most part, offshore providers don't buy their customers' desktops and mainframes as part of an outsourcing deal and they don't own software licenses. This fundamental piece of their business model allows them to deploy capital much more effectively and to be much more flexible in their approach to managing a customer's technology.

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