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research

2005 Global IT Outsourcing Study

While IT outsourcing is now an established management practice the landscape continues to change in surprising ways. DiamondCluster's 2005 Global IT Outsourcing Study reveals that buyers in growing numbers are: dissatisfied with offshore service providers, prematurely terminating contracts and struggling to harvest the full value of their outsourcing relationships. While India and the US are still the top locations for outsourcing services, interest in China is growing, which is bound to put downward pressure on rates. But while this evidence of a maturing market suggests challenges for outsourcing providers, the news appears better for the IT staffs at US companies. While senior executives still view outsourcing as a cost-cutting opportunity, they also recognize outsourcing's value as a means to manage variable demand from the rest of the business and to redeploy in-house IT personnel for more crucial purposes.

DiamondCluster's third global IT outsourcing study polled hundreds of senior executives from buyer and provider organizations for their opinions concerning various IT outsourcing topics. The results of this study are interesting, informative and at times frightful. Again this year the study focused primarily on outsourcing strategy, provider selection processes and trends, outsourcing management and lessons learned. We also studied trends in the industry over the past 12 months in the areas of spending, buyer satisfaction, outsourcing impact and leadership of the changing outsourcing market.

This research is intended to help organizations understand the latest trends in IT outsourcing, leverage experiences from respected executives that operate at the core of outsourcing initiatives, formulate their own set of best practices and to gain new insights into the prerequisites for successful outsourcing initiatives.

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DiamondCluster 2005 Global IT Outsourcing Study
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EXECUTIVE SUMMARY

Outsourcing An Industry at a Crossroads

Virtually all of the buyers of outsourcing services in the latest study have outsourced at least some of their IT functions. This is up from 80 percent a year ago, reflecting the continued growth in the outsourcing market. Additionally, 74 percent of buyers expect their use of IT outsourcing to continue to increase in the coming year (up from 64 percent in 2004). However, it is also important to note that seven percent of buyers told us that they were going to decrease their use of onshore outsourcing and five percent said they would do the same for offshore outsourcing. These are the first declines we've heard of; no one told us that they were planning to decrease their level of outsourcing in previous years.

Most buyers are now several years into at least one outsourcing relationship but despite this, we have found that many buyers still do not have effective metrics and measures in place to gauge the success of their outsourcing initiatives. As one IT Executive told us, "If you cannot measure it, how can you know if you are satisfied?" Providers say that one of their greatest concerns is meeting unrealistic and/or immeasurable buyer expectations. This is especially true in the world of offshore outsourcing where buyer satisfaction rates have plummeted from 79 percent in 2004 to 62 percent today.

This dichotomy reveals that the IT outsourcing marketplace has reached a crossroads. On one hand, buyers say they are feeling more comfortable that the basic value proposition – quality service at a lower cost – is attainable. On the other, the number of buyers that have abnormally terminated an outsourcing relationship in the past twelve months has more than doubled to 51 percent today versus 21 percent a year ago.

Among other key findings in DiamondCluster's 2005 Global IT Outsourcing Study:

- The threat of employee backlash is still a major concern among buyers (88 percent) and providers (86 percent) but worries about U.S. anti-outsourcing legislation and political pressure have fallen significantly since the most recent presidential election.
- Forty percent of buyers expect to outsource some IT functions to China over the next three to five years, versus eight percent who were making those plans only a year ago.
- Buyers remain skeptical about outsourcing mission-critical services. The greatest demand will be for application maintenance and support.

Profile of the Participants

DiamondCluster's 2005 Global IT Outsourcing Study includes the insights of 210 buyers and 242 providers of outsourcing services. All of the participants are either directly involved or highly aware of their company's outsourcing-related decisions.

The number of total employees in the participating companies ranged from 100 to more than 50,000. The number of IT employees on staff ranged from less than 100 to more than 50,000. IT budgets of participating companies ranged from less than \$5 million to more than \$500 million. Buyers participating in the survey conduct business in the financial services, professional services, insurance, consumer products, retail, telecommunications and public sectors.

The providers participating in the study range in size from less than 100 to more than 10,000 employees. Many of the outsourcing providers had operations in multiple locations, including Brazil, Canada, China, Egypt, France, Germany, Hungary, India, Malaysia, the Netherlands, Romania, Russia, Spain, Ukraine, the United Kingdom, the United States, and Vietnam.

About DiamondCluster

DiamondCluster International (Nasdaq: DTPI) is a premier global management consulting firm that helps leading organizations develop and implement growth strategies, improve operations and capitalize on technology. Mobilizing multidisciplinary teams from our highly skilled strategy, technology and operations professionals worldwide, DiamondCluster works collaboratively with clients, unleashing the power within their own organizations to achieve sustainable business advantage. DiamondCluster is headquartered in Chicago, with offices across Europe, the Middle East and Latin America.

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What is Going On Behind The Numbers?

While their experience with outsourcing is growing, buyers still find it very difficult to execute an optimal sourcing strategy. Buyers that viewed outsourcing as a series of transactions over the last few years are now recognizing the unintended consequences of not having a sourcing strategy. When building sourcing relationships one transaction at a time, many organizations forget to assess the overall impact on their training requirements, recruiting practices and career paths. It is only later that they recognize the implications to these functions and have to scramble to fill the inevitable gaps.

At the same time, providers of IT outsourcing services have finally realized that it is not in their best interest to differentiate on the basis of price. They are striving to build deeper technical skills, even as the market for offshore talent heats up and it becomes harder to attract and retain top employees. While rates appear to have stabilized they will start to increase in the near term -- that is, until China enters the market in a big way.

While this year marks the first decline in satisfaction with offshore outsourcers, sending commodity IT operations and processes offshore remains attractive. As the industry matures, however, buyers need to become more rigorous in thinking about sourcing strategically and in utilizing the appropriate metrics to confirm that they are using the right resources for the right functions.

It is incumbent upon the CIO and senior IT management to engage in sourcing discussions at a strategic level. Buyers told us that at present their CEO, COO and CFO are less engaged in outsourcing decisions than they have been in the past. While this represents a vote of confidence it may also be a missed opportunity. Outsourcing decisions shouldn't be made solely on the basis of cost savings. They should be part of a larger debate about how IT can enable the enterprise to meet its growth and profit objectives.

Research Scope

DiamondCluster International conducted its third in-depth study of the IT outsourcing industry to gain additional understanding of the perspectives of both outsourcing buyers and providers. The study focused on outsourcing spending and adoption patterns; buyer satisfaction; outsourcing risks; strategy and approach; management practices; the provider selection process; and trends within the community of outsourcing providers. By comparing and contrasting findings from previous years we are able to track the evolution of this maturing industry.

The universe of respondents we surveyed in late 2004 and early 2005 provides a representative overview of opinions on key IT outsourcing issues from the executives who know them best: actual buyers and providers of IT outsourcing services.

Our quantitative research methodology included a comprehensive survey of key decision makers ("buyers"), principally in large U.S. companies across multiple industries. In addition, we surveyed senior executives ("providers") at IT outsourcing services firms based around the world.

OUTSOURCING SPENDING & ADOPTION

“Nothing is sacred; however, it is obvious that there are some things where closeness to the business matters or skill sets aren’t readily available that you need to focus on in-house.”

– Managing Director, Financial Services

The last 10 years have seen tremendous change in the outsourcing landscape. On the provider side, new firms in offshore locations have emerged as leaders, while traditional IT services firms have had to scramble to catch up by building lower cost delivery and support centers. We asked buyers of outsourcing services in which year they first began outsourcing IT functions. Only 20 percent had outsourced any IT functions prior to 1996. Between 1996 and 2000, however, that number had grown to over 55 percent and today sits at virtually 100 percent.

How are buyers and providers feeling about the future? Will spending and adoption rates continue to increase, level off or perhaps even decline?

Use of Outsourcing is Growing but so are Questions about Value

Buyers of outsourcing services generally expect to increase their use of IT outsourcing in the coming year. Seventy-four percent of study participants (64 percent in 2004) plan to increase their level of IT outsourcing in the next 12 months. While this is an increase from last year, it is also important to note that seven percent of participants told us that they were going to decrease their use of onshore outsourcing and five percent said they would do the same for offshore outsourcing. These declines are important to note in that last year no one told us that they were planning to decrease their level of outsourcing. This data, coupled with the qualitative insights we gathered from in-depth discussions with buyers, points to rising concern among buyers that they are not getting the value or performance improvements they expected from their outsourcing relationships. We expect buyers to become more results-focused over time, but in the interim we predict some outsourcing arrangements will not be extended once they reach their contractual termination points.

Further evidence of the heightened challenges facing offshore providers was found when we asked buyers about their plans to move operations offshore. Seventy percent of buyer participants told us that they were going to increase their use of offshore outsourcing

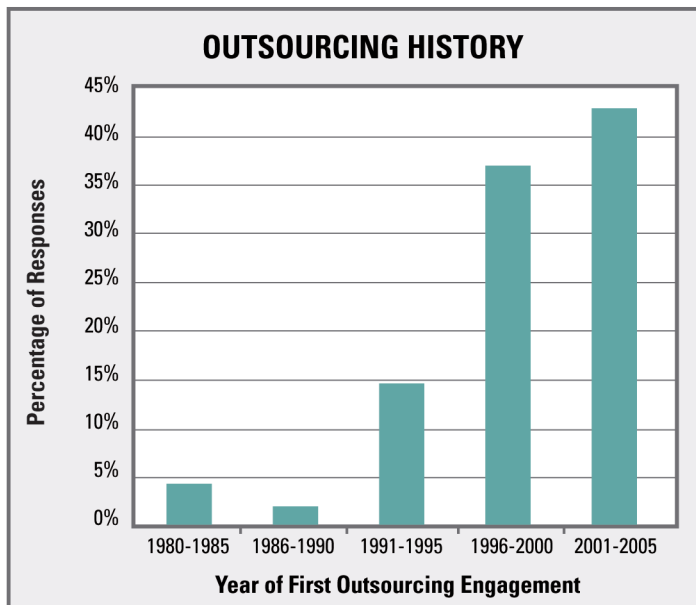
over the next 12 months. This represents a significant decline from 86 percent a year ago, but is still a substantial increase over the 32 percent in 2002.

We believe that the reduction in offshore outsourcing growth rate projections is largely a result of two factors. First, more companies are realizing that the cost benefits of offshore outsourcing are not always worth the effort when compared to the costs of equivalent onshore (or near shore) outsourcing. This is why developing a sound sourcing strategy with a comprehensive cost-benefit analysis is imperative to long-term success. The second factor is that buyers have already outsourced many of the more commoditized IT functions that have been the traditional mainstays of the offshore movement. The focus is now shifting towards more specialized services such as data center operations and real-time production support. Buyers historically have not viewed these types of services as conducive to offshore outsourcing. Providers of offshore outsourcing services, however, recognize this and are working quickly to overcome these barriers of perception. Whether they can be successful or not remains to be seen.

Providers Less Optimistic About Offshoring Growth

When we asked providers of IT outsourcing services for their thoughts on buyer spending trends for the coming year, they were slightly more upbeat than the buyers, but significantly less optimistic than they were a year ago. Overall, 81 percent of providers expect buyers to spend more on outsourcing than they have in the past (this is down from 90 percent a year ago and from 100 percent in 2002). When it comes to offshore outsourcing, 83 percent of providers expect buyer spending to increase over the coming year. This represents a significant decline from 97 percent in 2004. It appears that providers are more cautious in their current outlook and recognize that the growth rates for outsourcing must slow down over time.

Interestingly, while 11 percent of providers told us that they expect a decrease in spending for onshore outsourcing, none of them expect any decrease at all in offshore outsourcing. In the mind of providers, offshore outsourcing still represents the area of most significant growth opportunity.



BUYER SATISFACTION

Buyer satisfaction with IT outsourcing endeavors overall has risen slightly since DiamondCluster's 2004 study. A year ago, 74 percent of study participants indicated that they were satisfied with the results of their outsourcing efforts. Today, that number has risen to 78 percent; however, all is not good for the providers. While overall satisfaction may have grown, so has overall dissatisfaction. Last year, 10 percent of survey participants were dissatisfied with their outsourcing endeavors (down from 23 percent in 2002). This year 15 percent are dissatisfied with at least some of their outsourcing efforts. Interestingly, no buyers indicated dissatisfaction with both their onshore and offshore relationships.

- As offshore firms continue expanding their breadth of capabilities, the work becomes more complex and less commoditized. As a result, many firms are learning about industry and business processes "on the job." This leads to higher costs, more missed deadlines and overall lower client satisfaction.

Despite the downturn in satisfaction with offshore outsourcing over the past year, we remain convinced that offshore outsourcing is here to stay. As the industry matures, however, buyers need to become more rigorous in thinking about their sourcing strategies and utilizing metrics to confirm that they are using the right resources for the right functions.

Not surprisingly, when we asked providers their thoughts on buyer satisfaction, they were much more bullish. Overall, providers thought that both their onshore and offshore customers were generally more satisfied than in previous years.

	Buyers					Providers	
	Today			2004	2002	Today	
	OVERALL	ONSHORE	OFFSHORE	OVERALL	OVERALL	ONSHORE	OFFSHORE
Satisfied	78%	81%	62%	74%	69%	84%	86%
Neutral	7%	11%	30%	16%	8%	16%	7%
Dissatisfied	15%	8%	8%	10%	23%	0%	7%

Measuring Benefits: Reallocating Resources Trumps Cost Savings

This year, we asked buyers to tell us about the actual benefits they have received through IT outsourcing and if those benefits are meeting their expectations.

As we suspected, cost savings was not the most frequently cited benefit. In fact, the re-allocation of internal resources to more critical functions (83 percent of respondents) was the benefit buyers most often cited. This suggests that many organizations resist instituting internal headcount reductions as a result of outsourcing. It is far less painful for an organization to reassign those redundant resources to other, often more strategic, activities while also avoiding the employee turmoil and backlash associated with work force reductions. In addition to reallocating resources and cost savings, companies also cited faster time to market, increasing shareholder value and avoiding the need to discontinue or reduce products or services as benefits of IT outsourcing.

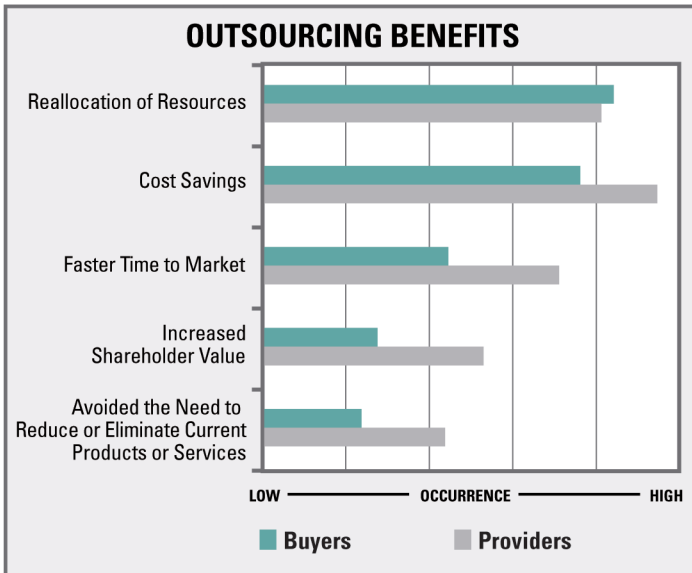
In general, providers agreed with buyers on actual benefits realized, although they thought the occurrence of each benefit to be substantially higher. For example, 95 percent of providers claimed that their buyers had achieved cost-saving benefits.

Offshore Satisfaction is Declining

When considering buyer satisfaction, the picture for offshore providers is not very pretty. A significant change from prior studies is that buyers are no longer more satisfied with the services of their offshore outsourcing providers than with onshore providers. In 2004, 74 percent of study participants were satisfied with their onshore outsourcing initiatives. Today, that number has risen to 81 percent. Offshore outsourcing satisfaction rates, however, have fallen significantly over the past year from 79 percent to only 62 percent today.

We believe that there are several major contributing factors to the decline in offshore outsourcing satisfaction. These factors include:

- The explosion of offshore outsourcing has caused enormous job growth in many locations, particularly in India. As a result, there is fierce competition for the best resources. This has led to unexpectedly high employee turnover rates, making it difficult for many offshore outsourcing firms to keep their staffing commitments to their buyers.
- The huge demand for offshore resources has also caused tremendous growth in the number of firms providing outsourcing services. While most of these firms are of high-quality, it is inevitable that some are not. As differentiating between offshore providers remains difficult, buyers risk selecting lesser quality firms based solely on price differential.



The art of managing customer expectations is important to any long-term business relationship but this is an area where providers have been found wanting. Only nine percent of buyers say that the benefits of outsourcing have exceeded their expectations and only 37 percent indicated that the benefits have met all of their expectations. Forty-eight percent of buyers said that their outsourcing relationships have met some of their expectations. On a more positive note, not one buyer reported that none of their expectations had been met.

Providers believe they are doing a much better job in meeting buyer expectations. Twenty-seven percent of providers told us that they are exceeding buyer expectations and 52 percent said that they were meeting all expectations. Only 19 percent said they were partially meeting buyer expectations and, like the buyers, none said that they had not met any expectations. In this area, the buyers and providers agree. All outsourcing arrangements appear to meet at least some expectations. We believe the high incidence of only partially met expectations is largely due to four factors.

- Unrealistic or poorly defined expectations established at the outset of the relationship
- Poorly defined metrics and measures for gauging benefits and success
- Provider deficiencies in delivering against expectations
- Buyer deficiencies in managing their providers

Simply put, it is a two-way street: buyers and providers share the responsibility for not meeting more expectations. However, if providers expect to deliver results that will engender mutually beneficial, long-term relationships, more work needs to be done

to establish “win-win” arrangements and proactively manage expectations throughout the duration of the contract.

Abnormal Terminations on the Rise

Our 2004 study found that 21 percent of buyers had abnormally terminated an outsourcing relationship in the prior 12 months. The most common reasons for those terminations, according to buyers, were when providers face financial difficulties, fail in delivering on commitments or when buyers consolidate their portfolios of outsourcing providers.

We found far different results this year. The percentage of buyers reporting that they have abnormally terminated a relationship in the past 12 months more than doubled to 51 percent. The primary reasons cited for these terminations included:

- Poor provider performance (36 percent)
- Change in strategic direction (16 percent)
- Function moved in-house (11 percent)
- Cost savings not achieved (7 percent)

Another 13 percent of buyer respondents reported that they had terminated a relationship due to the natural expiration of the contract. So, even though satisfaction rates have gone slightly up, these findings suggest an undercurrent of dissatisfaction and an inability among some outsourcers to retain the long-term relationships that are the lifeblood of their organizations.

When we asked providers about abnormally terminated relationships, we were also surprised. Whereas in 2004 only seven percent of providers were willing to admit that they had a contract abnormally terminated in the

past 12 months, this year the number has risen to an astonishing 49 percent. The reasons for these abnormal terminations did not match with buyer perceptions.

According to providers the most frequent reasons included:

- Buyer went out of business or was no longer viable (20 percent)
- Buyer change in strategic direction (19 percent)
- Buyer moved function in-house (12 percent)

Poor provider performance, cost savings not attained and buyer breach of contract were cited in no more than 5 percent of the cases.

Who is to Blame?

We believe that the dramatic rise in abnormal terminations is due to several primary factors:

- The explosion in the number of outsourcing providers between 2002 and 2004, coupled with their difficulty in differentiation, resulted in many buyers establishing relationships with sub-par providers. As the industry consolidates and the poor performers are weeded out, we expect the number of abnormal terminations due to poor performance to decline once again.
- Providers need to continue to focus on understanding real buyer needs and expectations. The days of simple wage arbitrage are almost over. Providers need to understand complex industry processes, develop deep areas of technical expertise and most importantly establish a better pattern of exceeding buyer expectations.
- Buyers are still underestimating the complexity and overhead associated with successfully managing outsourcing relationships. Buyers need to dedicate more time and energy to monitoring and measuring performance in order to identify and remediate issues before they escalate and jeopardize the entire relationship.
- Many buyers still view outsourcing relationships as transactional rather than strategic. As more buyers begin to develop comprehensive sourcing strategies that include views into internal and external resource allocation, they will become more efficient in their use of outsourcing and develop more successful relationships.

As in the past, we believe that while it is true that some arrangements go bad solely as a result of provider or buyer failure, the root cause is more likely to be a mix of shortcomings on both sides of the arrangement.

OUTSOURCING RISKS

As the outsourcing market matures, new risks emerge. Buyers' ability to handle both internal and external risks will go a long way in determining the success of their outsourcing initiatives.

Major Risks: Complexity, Effectiveness, Quality

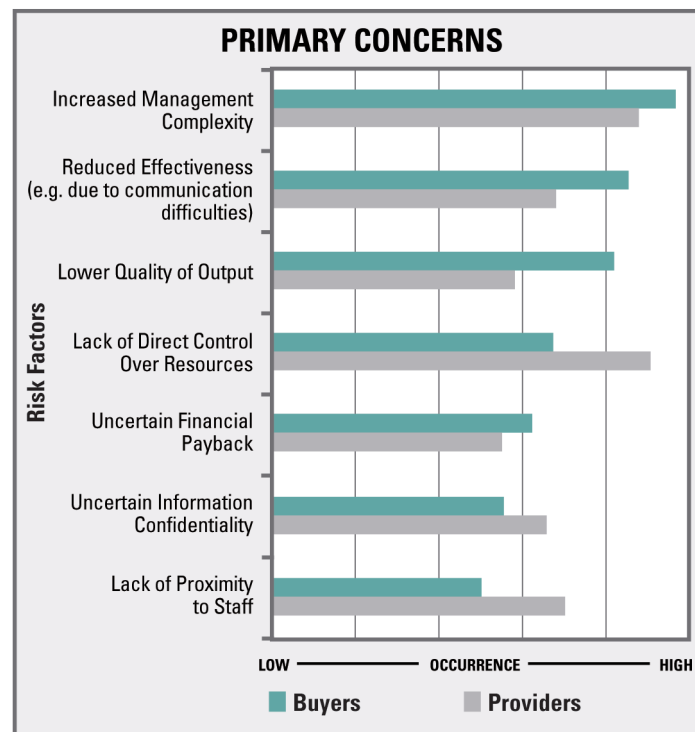
Buyers' major concerns about outsourcing continue to evolve. In 2002, buyers were worried about the uncertainty of financial payback and whether outsourcing was going to be a good investment. Last year, concern shifted to the potential reduction in operational effectiveness due to the challenge of managing resources that could be thousands of miles away. Today, most buyers feel that management complexity is the greatest risk, followed closely by reduced effectiveness and lower quality. Concerns about financial payback, the location of staff and information confidentiality remain lesser concerns in the minds of buyers.

A particularly important finding this year is that once again buyers are concerned about the quality of work they are getting from their outsourcing providers. We believe that concern is a result of several factors. In some cases the issue is poor provider performance, but in many cases it is a matter of buyers not setting the right expectations and then measuring quality against those expectations.

We believe buyer concern about management complexity is caused by two primary factors.

First, buyers are using more providers to meet specific needs and to reduce the operational risk of having work concentrated in one location. Thus, buyers are being challenged by managing a multitude of provider relationships. Second, new laws and regulations have increased the need for more stringent governance over company operations, including outsourced services. These factors, along with the usual complexities of managing an outsourcing relationship, have finally driven buyers to acknowledge that their ability to manage relationships effectively is the most critical element to outsourcing success.

There are some significant gaps in perception between buyers and providers regarding the perceived risks of outsourcing today. Providers find themselves having to provide buyers with more supporting documentation and perform more frequent reviews relative to operational processes and procedures. They realize that buyers are more concerned about issues associated with management complexity than about financial payback or information confidentiality. There are, however, areas where providers still do not fully appreciate how their buyers feel about risk. Providers overestimate buyers' concerns about resource control and proximity, but surprisingly underestimate how concerned their customers are about the impact of reduced operational effectiveness and quality of work. This is an area where providers need to focus in order to differentiate themselves from their competition and maintain long-term relationships.



Backlash Concerns Remain but Focus Shifts

Buyers were questioned again this year about several specific factors influencing their outsourcing decisions. Fueled by the presidential election and campaign rhetoric of 2004, buyers in the United States were wary about the potential for anti-outsourcing legislation and political pressure against outsourcing. While 85 percent of the buyers then were concerned about legislation and politics, that number has fallen sharply to about 50 percent today. The threat of employee backlash over outsourcing initiatives, however, is still a major concern of both buyers (88 percent) and providers (86 percent).

Interestingly, buyers are not very worried about the effects of competitor criticism or union pressures on their outsourcing endeavors. We feel that this demonstrates that outsourcing has become an integral part of today's business strategy. As for a lack of concern about financial markets, strategies like outsourcing that succeed in reducing costs, increasing efficiencies and expanding market presence are typically received positively.

Buyers are, however, worried about employee severance costs, the reaction of their customers and about negative publicity in general. We find buyers who are proactive about developing and executing communications plans targeted to internal employees and their customers experience a smoother transition to outsourcing.

Outsourcing providers are well attuned to the sensitivity surrounding outsourcing relationships. They cited employee backlash as the factor most worrisome for buyers. As a result, many limit their presence on client sites to keep the "face of outsourcing" out of sight from company employees. They are also well aware that employee severance costs, negative customer reactions, and negative publicity are significant buyer concerns. However, providers are under a false impression that most buyers remain threatened by anti-outsourcing legislation. This misconception is most likely due to offshore providers lacking full transparency into information in buyer markets.

Is the World Safer?

In light of ongoing geopolitical issues, we again explored the impact that current world events are having on offshore outsourcing decisions. Today, despite war, terrorism, and the continuing tensions in the Middle East, buyer assessments of global stability have generally improved. In 2004, 78 percent of buyers said that global stability concerns were impacting their outsourcing decisions. Today, that number is down to 68 percent. As for providers, 65 percent express concern today vs. 69 percent in 2004. We feel that these changing buyer and provider opinions reveal that other concerns are taking precedence and that the larger world conflicts are concentrated in regions not typically known for outsourcing.

WHAT ARE BUYERS CONCERNED ABOUT?		
Type of Risk	Buyers	Providers
Employee Backlash	88%	86%
Employee Severance Cost	67%	63%
Customer Reaction	66%	63%
Negative Publicity	65%	65%
Legislation	52%	68%
Political Pressure	48%	58%
Market Reaction	36%	50%
Union Pressure	25%	53%
Competitor Criticism	20%	42%

PROVIDER TRENDS

As in years past, our study focused on identifying macro-level provider trends that are impacting the outsourcing industry. Recognizing these trends and their potential impact will help buyers and providers alike establish and maintain more successful outsourcing relationships.

Today's IT outsourcing services landscape is more complex than ever. There are more companies providing more services in more locations than ever before. We see companies that initially established themselves as low-cost providers in countries like India and the Philippines now seeking to, in essence, "out-source" some of their own operations by establishing operations in even lower cost countries. We also see new companies being established in emerging locations, including China and Eastern Europe, as entrepreneurs there seek to capture a share of the enormous IT services global spend. (Global spending on IT services is expected to reach \$585 billion according to estimates by the United Nations Conference on Trade and Development.)

Merger and acquisition activity continues as outsourcing providers seek to improve their market positioning by adding specialized skills, expanding the breadth of their offerings and increasing their location footprints. Providers are also establishing more offices in countries where they have large concentrations of buyers in an effort to influence upstream decision-making and improve customer relations.

Expanding Breadth of Services

In last year's study, we recommended that providers focus on developing deeper areas of specialization and enhanced industry expertise to establish and maintain competitive differentiation and to protect established rate structures. Apparently, the providers have been listening. They have invested in their

managed services capabilities, including specialized services such as PC Maintenance and Support, Network Management, and Database Management. Along with this expansion they also are experiencing increased demand from buyers for more traditional project services like application development and support.

As consolidation continues and as buyers become more savvy, providers must continue differentiating themselves with specialized services and skills. Providers that don't will find themselves on the losing end of the commoditization chain as they watch their margins erode and their employees leave for more exciting opportunities.

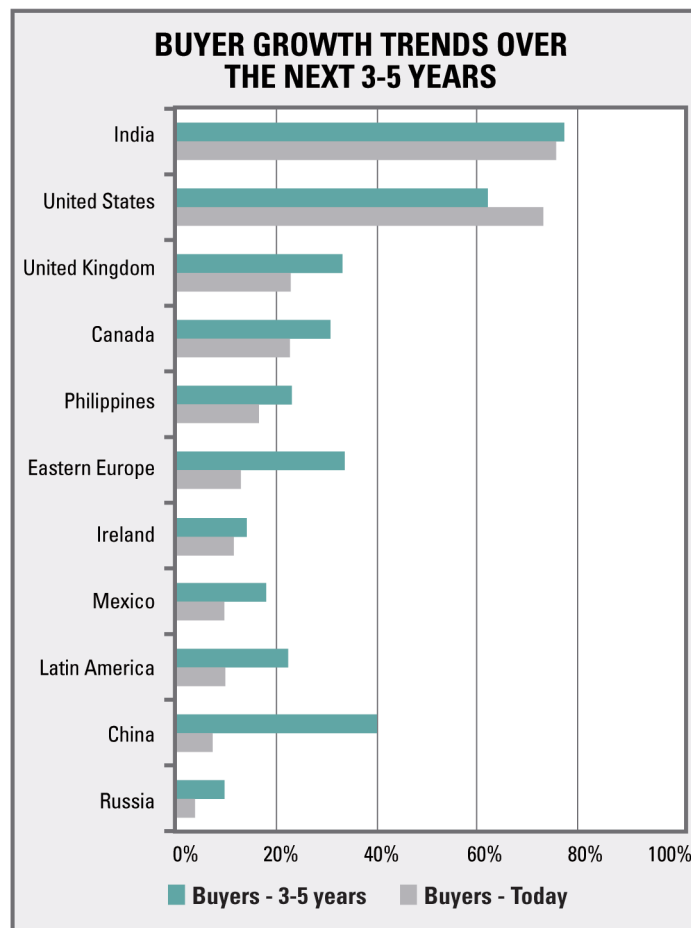
"China will change its intellectual property laws and become more fluent in the English language. That country will become dominant."

- Division Manager, Major Bank

Locations: China Gaining Momentum

The United States and India remain outsourcing hotspots. Approximately three-fourths of the buyer participants in our study outsource some IT functions to one of these countries. Likewise, the majority of providers have operations in one or both of these countries. The big news is China's emergence as a location for outsourcing services. In 2004 not a single buyer respondent said that they were actively outsourcing IT functions to China. Today, six percent of buyers say that they are in China.

When we asked both buyers and providers which countries they thought would be the leaders in providing IT outsourcing services over the next three to five years, the United States and India remained the most popular choices, but there was significant interest in emerging markets, such as China, Mexico, Latin America and Eastern Europe. For example, in 2004, only eight percent of buyers expected to establish outsourcing operations in China over a three to five year period. Today, this number has grown to 40 percent. Likewise, the growth rate projections for other locations have grown at smaller, but still impressive rates. Countries that appear to have fallen out of favor as outsourcing locations this past year include Israel and Russia.



The most aggressive providers are working diligently to establish operations in multiple locations. No longer are they taking a wait-and-see attitude in places like China and Eastern Europe. Instead they are establishing operations and working to grab market share ahead of their competition. Overall, providers expect to see the majority of their business in India, the United States, China and Eastern Europe over the next several years. When it comes to identifying the locations where outsourcing presence will not be as strong in the next three to five years, providers, like buyers, identified Israel, but they also included Mexico and the Philippines. Interestingly, many providers remain confident that Russia will continue to be a strong and viable location for outsourcing in the future.

“Costs will rise until China enters in earnest.”

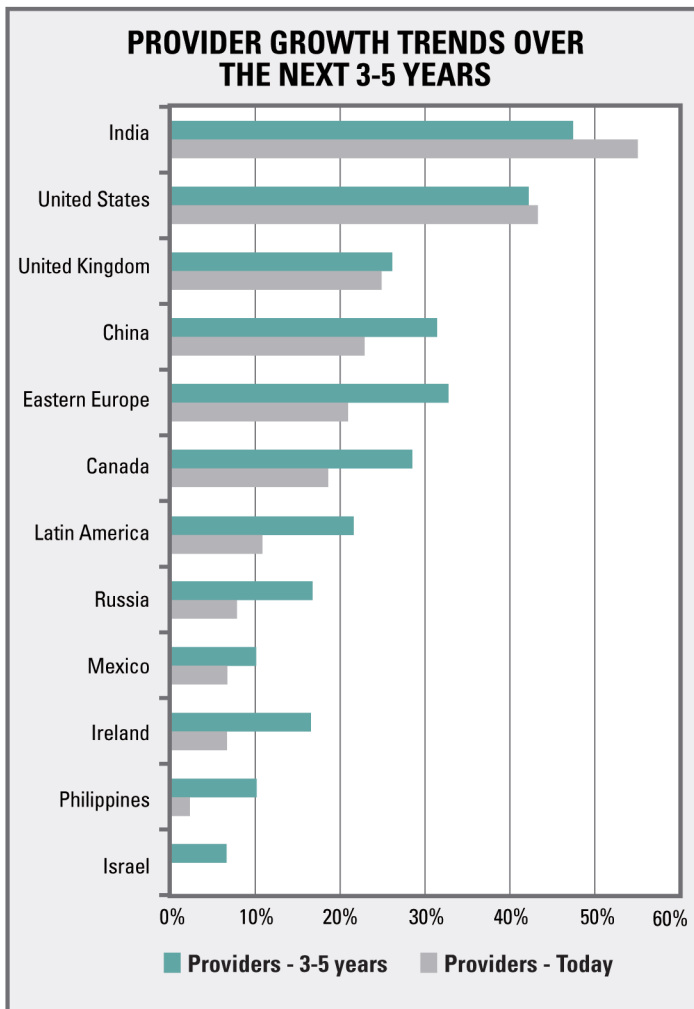
**- Director, Server Network Strategy,
Global Financial Services**

Buyers Conflicted on Changes in Outsourcing Rates

We asked buyers and providers how the market rates they pay or charge for outsourcing services have changed in the past 12 months. Although questions were asked separately for onshore services versus offshore services, the overall trends are similar.

Buyers this year offered conflicting viewpoints when asked about overall onshore and offshore rates. The majority feels rates have remained consistent with 2004 levels. However, roughly 25 percent believe overall rates have increased and 22 percent believe they have declined. We believe that this dichotomy is a result of providers getting much smarter about how they charge for services and structure relationships. Providers have been working hard to remove cost as a differentiator and it appears to be working. In buyers’ search for specialized services that meet their unique needs, they must be willing to balance costs and value in negotiating pricing. Traditional industry pricing benchmarks will be less reliable as an indicator of what buyers might expect to pay, particularly for the emerging category of managed services that outsourcers are offering.

Providers’ perspectives on onshore and offshore rates are similar. The majority of providers believe their rates have remained constant. More providers -- approximately 2 to 1 -- indicate an increase versus a decrease in rates. This shows an upward trend in rates across all services in comparison to last year. We feel that rising rates are predominantly a reflection of increased buyer demand around the globe as more companies utilize outsourcing as a strategic lever.



STRATEGY AND APPROACH

“Outsourcing decisions have to be made case by case.”

- European CIO, Financial Services

Outsourcing Rationale

Over the last several years there has been a gradual shift away from cost as the dominant driver for outsourcing decisions. The search for cost-savings is still paramount but the buyers of outsourcing services have identified several other compelling reasons for turning to outsourcing providers, which is good news for internal IT staffs.

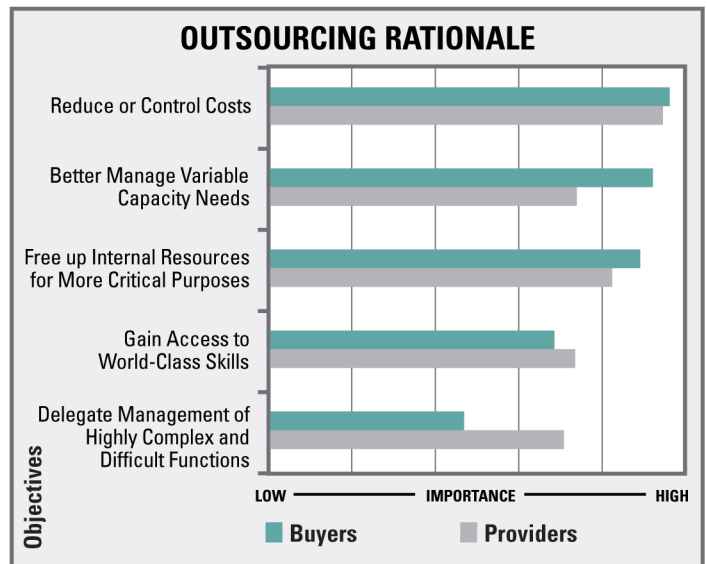
While controlling or reducing costs is still clearly top of mind for outsourcing decision-makers, two other factors -- better managing variable capacity and freeing up internal resources for more critical purposes -- are quickly rising in importance. We believe that this shift is indicative of two major trends. First, buyers have learned that it is often difficult to attain significant cost savings through outsourcing based on employee headcount reductions. This is partly due to strict employment laws in some parts of the world, but also because many organizations find it difficult to terminate employees at the rapid rates that are originally projected in many outsourcing business cases. As a result, more organizations are redeploying resources rather than reducing staff and tapping into pools of talented but poorly leveraged internal resources that they are now using more effectively.

The second major trend in outsourcing rationale is in using outsourced resources to manage fluctuating capacity needs. Sophisticated IT organizations recognize that demand ebbs and flows, often times either leading or trailing

economic cycles, depending on the industry, function and issue. The more demand for IT resources fluctuates, the more important it is to have a qualified stable of resources that can be drawn upon – without having the burden of having too many employees on staff when times are tough. Providers that recognize this need are becoming very adept at structuring relationships with provisions for “flex capacity” to meet the variable demands of their buyers. Likewise, buyers are gravitating to providers that best understand their particular needs and who can be flexible in structuring relationships that reflect the ebb and flow of demand.

Providers continue to be well-aware of what drives buyers to outsource. They understand that cost reduction is still a primary internal selling point buyers use to obtain approval and funding for outsourcing initiatives. Yet providers are also more optimistic than in previous years that buyers are outsourcing for more strategic reasons, such as access to world-class skills and as a means to free up internal resources for more strategic activities.

While buyer and provider views on outsourcing rationale are converging more each year, there are still two areas where they are not in sync. In general, providers underestimate the importance to the buyer of meeting variable capacity needs and overestimate the desire among buyers to outsource highly complex or difficult-to-manage functions. Buyers still appear most interested in outsourcing commodity functions first and only then start thinking about more difficult functions or processes.



What Should be Outsourced?

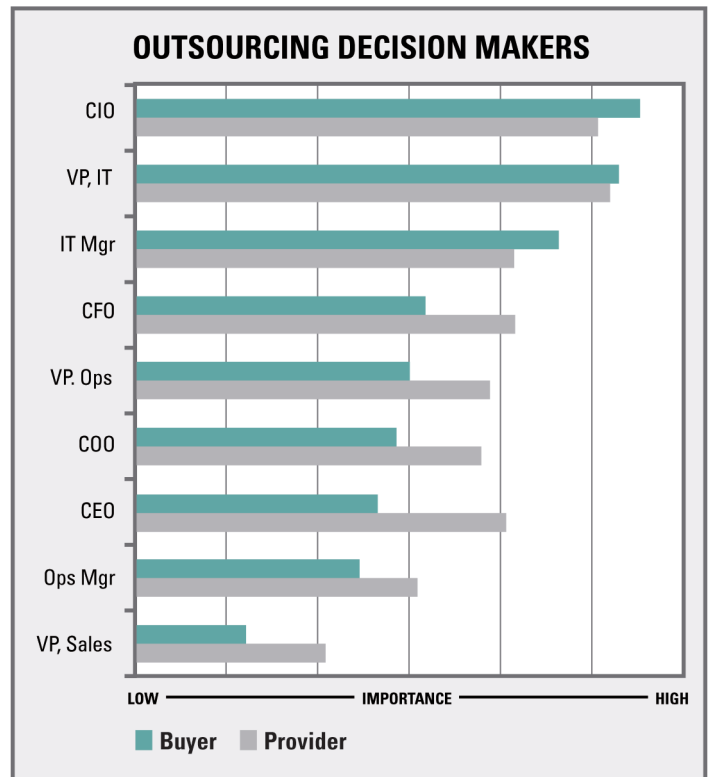
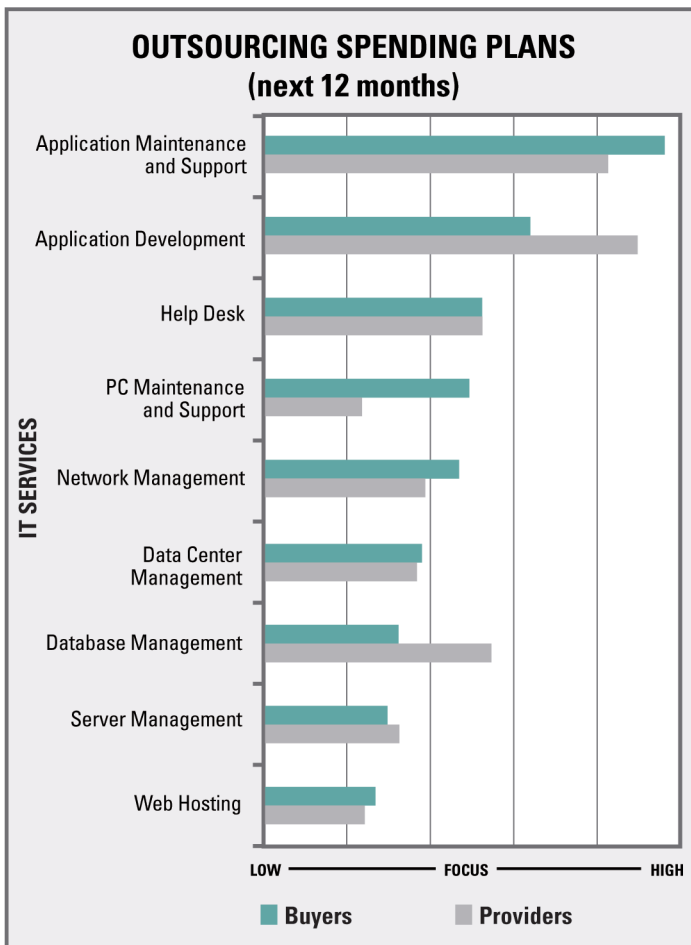
While buyers are beginning to think more strategically, this has yet to translate into changing purchasing habits. When buyers were asked to identify the areas that they expected to start outsourcing or to increase their level of outsourcing over the next 12 months the responses were quite revealing. Application maintenance and support has replaced application development at the top of the list. Web hosting has fallen to the bottom. In general, buyers are focusing their spending on more commoditized and standardized services, while shying away from large investments in managed services. We believe this indicates that buyers remain uneasy with outsourcing mission critical services and applications.

Providers tell us their primary focus still lies in delivering application development, maintenance and support services. However,

they also hold high expectations for growth in the managed services category, particularly in the areas of database management and network management. This suggests that providers are investing in building their skills and capacity in these areas. Subsequently, buyers will soon be able to take better advantage of these services but demand has not reached critical mass – yet.

Who Are the Decision Makers?

CIOs and other IT leaders continue to call the shots when it comes to purchasing outsourcing services. In past studies, buyers identified CIOs, Vice Presidents of IT, and IT Managers as the key decision-makers in IT outsourcing decisions. This year is no exception; those three titles are still taking on the largest roles in the decision-making process. Buyer respondents this year report that the CEO, COO and CFO are brought into the IT outsourcing process less frequently and with lower levels of interaction. The one major change that emerged from prior years is the increasing importance senior level operations executives are playing in outsourcing decisions. This is refreshing news, affirming that senior management realizes that IT outsourcing and business process outsourcing decisions are closely aligned and should not be made independently. IT executives should be comfortable with this trend because it is evidence of greater alignment between IT and the rest of the business.



Providers still tend to overestimate the importance of non-IT C-level executives, but they are also in lock-step with their buyers in understanding the increasing role of senior operations executives.

“Choosing the right outsourcing partner is critical. Attaining operational efficiency takes quite a bit of time.”

- Executive Director, Financial Services

Shifting Philosophy of Outsourcing Relationships

Buyer attitudes continue to oscillate when it comes to their approach to the use of outsourcing providers. In 2002, nearly one-third of buyers preferred to partner with a series of niche providers to fit their specific needs. In 2004, however, none of the buyers indicated that they preferred this approach. Today, the trend seems to be reverting slightly back towards provider specialization. Many buyers are more apt to select multiple providers that uniquely meet their specific needs rather than structure contracts with a single provider to deliver a broader set of services. Almost 70 percent of respondents this year said they were unwilling to partner with a single provider that could cover all of their needs; that is up seven percent from last year. We believe that this indicates the ongoing maturation of buyer purchasing habits. Buyers are spending more time upfront assessing their needs before starting the provider selection process. This increasing buyer maturity, coupled with less differentiation on the basis of cost, bodes well for high-quality, specialized outsourcers as they compete with the larger scale service providers.

Outsourcing Deals: Ownership Stake Becomes More Appealing

When it comes to structuring outsourcing relationships, buyers most often prefer partnering with independent providers (83 percent) rather than structuring other types of arrangements that would give them some ownership in the relationship. There is, however, a growing interest for alternative approaches that should not be discounted. For example, the number of buyers that have taken on some ownership position in an outsourced relationship has grown to 34 percent from 17 percent in 2004. Ownership can take the form of a joint venture, fully-owned subsidiary, or build-operate-transfer (BOT) arrangement.

When buyers seek an ownership stake in an outsourcing relationship, providers are more than happy to oblige. Twenty-one percent have helped develop a fully-owned subsidiary, 39 percent have formed a joint venture with a customer, and 30 percent have implemented a BOT arrangement. As providers look for more ways to generate revenue and spread risk, they are more willing to form complex partnerships with their buyers. We believe that joint ventures between buyers and providers will become more prevalent in the coming years. This will be especially true in the BPO market as early adopters strive to establish processing centers that they can leverage to sell services to other buyers.

BUYER ATTITUDES ABOUT RELATIONSHIPS

	2005	2004	2002
Partner with a single provider that can cover all your needs at one or multiple sites	21%	22%	15%
Partner with several providers with similar capabilities as a means of mitigating risk	29%	28%	31%
Treat each opportunity individually and partner with as many providers as necessary	39%	33%	54%
Other	11%	17%	0%

PROVIDER SELECTION

With strategy and implementation plans in place, buyers confront the challenge of finding the best-suited providers for their outsourcing needs. Navigating today's cluttered provider landscape is increasingly complicated, with more and more providers emerging in more locations throughout the world. Today's providers range in size from large, full-service firms that have tens of thousands of employees and IT resources in major cities across the globe to small, niche companies providing services in one or a few locations. Outsourcing providers are even turning to secondary outsourcers to expand their breadth of services. Each outsourcing model – full-service, niche, and blended -- presents a different level of risk, expertise, and quality. With all these choices, how do companies ensure they are making the right decision?

Tech Skills, Flexibility Among Key Buyer Selection Criteria

A key finding of this year's research is that the set of criteria that drive provider selection decisions continues to change. In our 2002 study, buyers focused on skill set, vendor size, contract flexibility, quality, and existing provider relationships to make their decisions. Last year buyers were primarily looking for references and reputation, cost and breadth of skills. Cost, of course, remains a constant concern, but today's buyers also are focused on technology skills and operating model flexibility.

The most sophisticated buyers are developing rich portfolios of providers as they implement strategic sourcing solutions that balance cost, risk and value. These buyers are very focused on the technical skills of their providers as they want to partner with someone that has the exact skill sets that they need. Increasingly important is the provider's willingness to be flexible in how they structure their operating models. The renewed value placed on flexibility in structuring operating models is a result of buyers wanting to be more nimble in the way they use providers. Historically, getting two competing providers to work together or having providers accept risk/reward sharing provisions has been difficult at best. Today, providers must be willing to partner with buyers in a wide variety of models and must show a willingness to adapt over time as dictated by changing buyer needs and business conditions.

With more competition among more providers, cost remains a major consideration in the selection process. This is being driven in part by the rise of outsourcers in new geographical regions (China in particular), with different cost fundamentals. So, while it may not be as much of a buyer's market as in the past, there are still significant wage arbitrage opportunities to be found. Organizations may just have to look a little harder or take on a little more risk to find them.

Last year, our study indicated that provider quality certifications had fallen in relative importance in the eyes of the buyer. We believed then, as we do now, that this was not an indicator of the devaluation of this attribute,

but rather the general lessening of providers' ability to differentiate themselves from one another along this dimension. In short, having a high level of quality certification is now expected of all providers. The difference between 2004 and today is that reputation and industry expertise appear to be going the way of quality certifications. They are still very important to buyers, but they are not being used to drive key selection decisions. These traits are simply part of the cost of entry in a very competitive, rapidly consolidating market.

As in 2004, provider market position, size and location are at the bottom of the list of buyer selection criteria. We believe that this is once again indicative of buyer opinion that there are quality providers of all shapes and sizes all over the world. As the outsourcing market continues to mature, we believe that size and location will continue to rank comparatively low in the eyes of buyers. We predict, however, that the market position of providers will increase in value among buyers. This will happen as providers establish themselves as market leaders in various industry segments or technology disciplines.

How Providers Perceive Selection Criteria

In prior surveys we found striking disparities of opinion between those criteria buyers thought were important and providers' perceptions of what their customers valued. The fact that this gap appears to be closing is additional evidence of a maturing outsourcing market.

Today, as in years past, providers rank cost the number one factor that they believe to be driving buyer selection decisions. However, providers now also recognize that cost is only one of several very important factors that drive purchasing decisions.

If providers better understand their buyers' selection criteria, are providers better able to differentiate themselves from their competition? It may never be easy for an outsourcer to distinguish itself from their competition, but there does appear to be a shake-out underway.

BUYER RANKING OF KEY SELECTION CRITERIA

2005	2004	2002
1. Technology expertise	1. References and reputation	1. Cost
2. Cost	2. Cost	2. Resource skill set breadth
3. Flexibility in structuring operating model	3. Resource skill set breadth	3. Size of vendor
4. Existing or prior relationship	4. Industry expertise	4. Flexibility of contract
5. References and reputation	5. Existing or prior relationship	5. Process quality

In 2002, providers told us that they distinguished themselves first by the quality of their work, next by industry expertise and third and fourth by their delivery and technical capabilities. Cost was a distant fifth on the list. Last year, however, cost skyrocketed to the top of the list of perceived selection criteria on the heels of increased competition and provider misunderstanding of buyer priorities. The result of this miscalculation was that providers kept their rates artificially low as they scrambled to win new business.

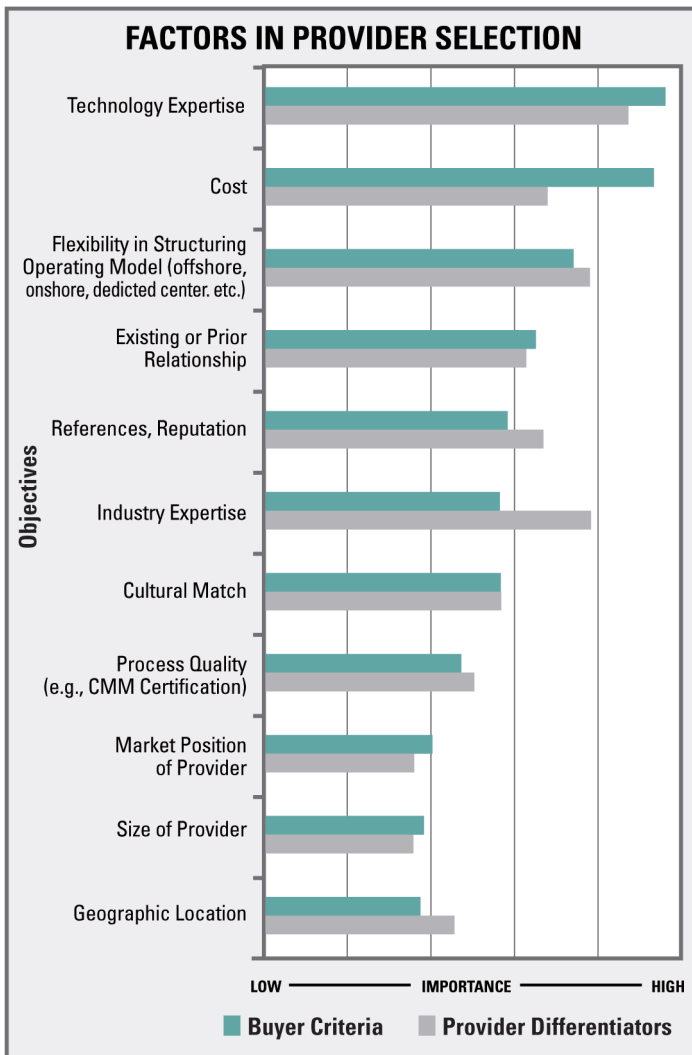
While providers still believe cost is the most important of the buyer selection criteria, they do not place it at the top of their differentiation list. This year, providers told us that they differentiated first on their technical expertise, and next on their industry expertise and flexibility in structuring operating models. Cost is fourth on the list, just ahead of reputation. These priorities are aligned closely with buyer attitudes. It also represents a significant maturation in the mindset of outsourcing providers and will quite possibly lead to increasing rate structures, since both sides

seem to agree that fewer buyer decisions will be driven primarily on the basis of cost.

For many CIOs not a week goes by without several outsourcing providers trying to schedule introductory meetings. Are provider efforts to differentiate themselves in a cluttered market actually effective?

Buyers tell us this year that it is easier to differentiate between providers than it was in the past. Last year buyers said that it was most difficult to differentiate between competing offshore providers. In fact, 58 percent of buyers found this to be difficult or very difficult. Today, this percentage has declined to 50 percent. While certainly not an improvement providers will be satisfied with, it does indicate that outsourcers are making progress in their marketing and branding efforts. We believe this shift represents a combination of buyers becoming better informed about their options and also of providers having a better understanding of how to differentiate themselves from their competition. The only area where buyers say that it is slightly harder to differentiate between providers is in selecting among onshore services. If onshore firms are losing their ability to differentiate themselves it does not bode well for established providers since cost becomes more of a driving factor when buyers cannot differentiate by other means.

We also asked providers how difficult they think it is to differentiate themselves from their competitors. Not surprisingly, providers generally gave themselves high marks. However, this self-assurance doesn't match the ongoing perception among many buyers that both offshore and onshore firms are in large part undifferentiated. For the outsourcers, the message is clear: more differentiation needs to be done. As for CIOs and other buyers: expect to continue getting a tremendous number of cold calls and direct mail for the foreseeable future.



IT OUTSOURCING MANAGEMENT

***“You get what you inspect,
not what you expect”***

- Senior Vice-President, Financial Services

Buyers continue to improve in their ability to effectively manage outsourcing relationships. Increased governance over performance metrics, onsite reviews and better provider relationships are becoming standard practice. However, buyers still fall short of extracting the full value from many outsourcing relationships. The reason is two-fold. First, many buyers are suffering from a lack of clear direction and management due to their reliance on ill-conceived and poorly managed metrics to drive decision-making. Second, providers are feeling pressured to meet targets on these very same misguided metrics without a compelling reason to do so.

Defining Service Level Agreements (SLAs): Balancing Risks and Rewards

Outsourcing contracts typically define a set of service level targets that must be achieved as part of the delivery of the outsourced service. A growing practice is the use of an incentive structure to reward or penalize providers based on their performance against agreed upon SLAs. In 2004, 61 percent of buyers told us that they used SLAs with reward or penalty clauses. Today, that number has increased to 75 percent.

With more buyers utilizing an incentive structure to influence provider performance, SLA management is becoming increasingly important. This year, 73 percent of buyer respondents indicated they were administering penalties, 27 percent were issuing rewards, and 25 percent were doing both. The unbalanced emphasis on penalties may indicate that buyers are establishing adversarial relationships from the outset and are not giving their providers enough incentive to over-perform and exceed expectations.

***“Don’t squeeze the provider too
much during contract negotiations.
Make sure SLAs are easy to measure
and administer.”***

- CIO, Consumer Goods

As a result, it is no surprise that providers have pushed back and prefer to structure SLAs that provide more balance between risk and reward. Fifty-six percent of providers include penalties, 44 percent include rewards, and 37 percent include both in typical outsourcing deals. Providers are very willing to put revenue at risk, but increasingly are asking buyers to do the same. Overall, buyers are still keeping providers on the defensive and increasing the pressure for them to perform or endure financial losses. The unintended consequences of these actions could have enormous effects on the success or failure of an outsourcing relationship. The next several years will prove to be instrumental in achieving the right mix of penalty and reward opportunities in successful outsourcing relationships.

Establishing Key Metrics

Buyers, in general, report that they are still closely monitoring their relationships through metrics reviews, site visits and qualitative relationship evaluations. These reviews are good for evaluating the high-level health of an outsourcing relationship, but often fail to surface issues directly related to the delivery of a specific project or service. To identify that level of performance in time for mediation and correction the appropriate quantitative metric measurement and tracking processes must be established. These metrics keep a constant pulse on the provider’s progress against established targets and can alert companies to issues before they escalate.

Buyer views on the most important measurement metrics have remained largely the same for the past two years. Buyers still view on-time delivery, cost effectiveness, and user satisfaction as the three most important areas of measurement. Unfortunately, we have found that many buyers lack the rigor, structure and discipline necessary to measure these areas in an effective manner. As a result, we have noticed a drop in buyer satisfaction rates, as well as lower provider success rates in meeting buyer expectations.

Providers, like buyers, have remained largely consistent in their views of how they are being measured -- with one notable exception. On-time delivery and cost effectiveness still rank at the top of the providers’ list. However, service availability has moved up into the number three position while user satisfaction has dropped in comparison to last year. Is this change important? We believe that the elevation of service availability in the eyes of the provider is indicative of a trend that more outsourcing providers are starting to focus on real-time services like data center operations and production support. Availability is critical for these services. It is also an indicator that is more easily measured in a quantitative manner. We also expect buyers to put more emphasis in this area in the coming year as they look to outsource more real-time processes.

Also of interest is that the timeliness of filling staffing requests – with quality individuals – is still a key buyer criterion. This reflects continuing capacity issues in the industry as providers struggle to attract and retain the best individuals. Many buyers have seen a large amount of turnover in their outsourcing provider’s staff over the past year and they are not happy about it. This is an area where providers will continue to struggle for some time as the industry matures and goes through inevitable consolidation and restructuring.

Proactive Performance Management

What level of relationship governance must companies establish to ensure the success of their ongoing outsourcing initiatives?

Establishing the correct delivery metrics and SLAs is only part of the equation. Consistently evaluating a provider's performance against those metrics is equally critical. For reviews focused on metrics, the numbers are almost identical to last year. The majority of buyers (68 percent this year compared to 70 percent last year) and providers (68 percent this year and 69 percent last year) report metrics reviews are performed monthly or more frequently. Twenty-one percent of buyers and 16 percent of providers report that they review metrics quarterly. The remaining respondents use a semi-annual, annual, or as-needed approach. We feel the consistency in these responses over the last few years is a sign that buyers have reached a comfort zone in the frequency of interaction required to effectively manage providers.

There has been a significant change in the last year in regard to site visits to provider facilities. In each of our past studies approximately 25 percent of buyers informed us they did not visit provider facilities. This year only 8 percent indicated that they did not visit their provider's facilities. Our prior two studies also indicated that only 25 percent of buyers performed these visits quarterly or more often. Today, that number is 42 percent. These results demonstrate that buyers are reacting to the need for stricter governance over their outsourced operations, and feel a greater sense of control by holding regular face-to-face discussions.

Managing the Relationship Overall

It is extremely important for buyers, as part of a comprehensive sourcing strategy, to periodically evaluate their overall satisfaction with their outsourcing relationships. Assessing and affirming metrics, SLAs and overall provider commitment to delivering value should be part of this due diligence process. We polled study participants to better understand how buyers review their overall outsourcing relationships and the frequency with which they conduct these reviews.

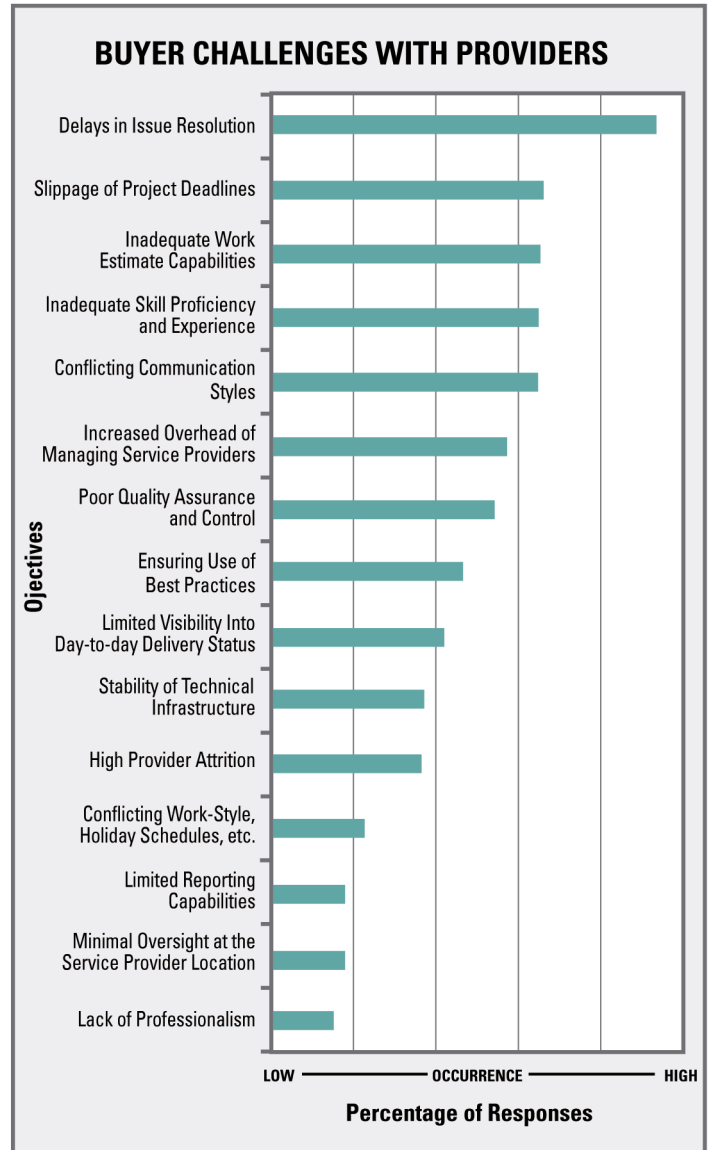
Buyers are assessing the value delivered by their outsourcing providers more often than in the past. Last year, nearly 50 percent of buyers said they carefully evaluate their overall outsourcing relationships on an annual basis. Today, 51 percent of buyers perform due diligence on existing provider relationships

each quarter and 19 percent do it even more often than that. This is a significant shift from last year and demonstrates how buyers are dedicating more time to ensuring they have the optimal provider relationships in place.

Overcoming Key Relationship Challenges

This year's study asked buyers and providers about the challenges they face with one another related to service delivery. Buyers were most

concerned about impacts on day-to-day operational activities, including delays in issue resolution (56 percent), while missed project deadlines, inadequate work estimation capabilities, inadequate skills, and conflicting communication styles were all cited by 40 percent of buyer respondents. The timing of issue resolution and the delivery of projects is relatively easy to measure and improve upon, even from a distance. The increased emphasis we are seeing on more reviews with providers is due in part to these secondary but essential aspects of outsourced delivery, communications and resource skill proficiency.



Providers are well-aware of the obstacles buyers face in managing outsourcing relationships. Conflicting communication styles (26 percent) and delays in issue resolution (22 percent) were also on their list of buyer complaints. However, providers differ in opinion when it comes to the notion of having inadequate skills, with only nine percent indicating that they have had a problem in this area. There is a large disconnect between buyers and providers regarding the capabilities of provider personnel. This is not surprising given that offshore providers are experiencing high attrition rates. In our opinion, providers should re-focus their efforts on recruiting and managing outstanding people as this will become a key competitive differentiator.

Finally, we asked providers to tell us about the key challenges they have faced when dealing with buyers. Not surprisingly, the challenge most often cited was unrealistic buyer financial expectations (52 percent). Following closely behind that was a lack of clear directive (45 percent). Grouped closely together in third place, with 34 to 39 percent each, were the issues of poor decision-making, poor project management, and low executive commitment. All of these challenges are indicative of buyers not adequately managing their outsourcing relationships.

We believe that for buyers and providers to truly be successful in working together, their relationship must include four key components:

- Buyers must treat sourcing as part of an overall strategy and not as a set of transactions as a means to cut costs
- Buyers and providers must establish win-win propositions where neither party feels like they have been taken advantage of
- Buyers must establish clear and meaningful metrics and measures to gauge the success of their outsourcing endeavors
- Providers must continue to strive to understand buyer demands and focus on exceeding all customer expectations



LESSONS LEARNED

In the qualitative portion of our research we asked Buyers and Providers to share their insights and experience with their peers. The following is a representative sample of their first-hand observations from the front lines of outsourcing.

Buyers

- Outsourcing is always harder than you originally thought.
- Cost savings alone is not a good reason to outsource.
- Leverage resources with experience and skills in outsourcing to help you develop your own sourcing strategies and execution roadmaps.
- Clearly define your goals, measurement metrics and exit strategies up front.
- Well-defined governance structures and proactive management and communication are the keys to success.
- Structure your vendor relationships as win/win propositions.
- Outsourcing your problems won't solve them. You should fix potential problems first before you hand over the process to someone else.
- Establishing very specific and measurable SLAs is crucial for evaluating performance.
- Give providers a chance to be successful. Transitions take time.
- Due diligence on providers is essential if you want to avoid surprises.
- Internal resistance to outsourcing can be managed but you have to foster proactive and candid communications to succeed.

Providers

- Successful outsourcing requires strong buyer commitment.
- Be prepared to talk to buyers in terms of business value.
- Buyers and providers need to be long-term partners.
- Buyers should recognize that providers need time to be effective. Bringing on an outsourcer can't happen over night.
- Buyer expectations and objectives are always evolving. Make sure you understand them at the outset and are nimble enough to satisfy them when they change.
- Resistance to outsourcing and uncertainty about its value are still issues in many organizations.
- Contracts and negotiations need to be customized for each situation.
- It's still difficult for outsourcing firms to differentiate themselves and cost is still very important to buyers.
- You've got to be able to work closely and communicate clearly with buyer management to be successful.
- Cultural differences need to be acknowledged and managed.
- Establishing a mutual understanding about governance structures, SLAs and performance expectations is critical.

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