THOUGHT LEADERSHIP

MID MARKET SECTOR – OPPORTUNITIES & CHALLENGES

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Outsourcing and global sourcing has contributed significantly to the globalization of services in the past two decades. The earliest adopters have been large multinationals, with the global service provider landscape focusing on satisfying not just the cost-savings oriented demands from such organizations, but also evolving to provide value-added services that have today transformed outsourcing from a bottom-line focused endeavor to a top-line oriented one. The United States has been a principal driver of outsourcing and global sourcing, resulting in a slew of organizations from a large number of developing nations creating compelling value propositions that could satisfy demand. However, one key sector of the United States economy has been ignored - the thousands of small and medium-sized organizations. This sector has been ignored by most service providers given their focus on providing services that could leverage scale and thereby enable garnering significant bottom-lines. On the flip side, the larger organizations with entrenched cost-structures were under severe compulsions to incorporate much needed flexibility through significant cost reductions, hence their focus on volumes and scale, which fitted in nicely with the propositions from service providers. However, in today's environment of increasing costs and other complexities, service providers are moving up the value-chain with their services, and this is a strategy that removes the restrictions on their ability to serve a particular size of customer organizations. Consequently, it has become vital to understand how the mid-market sector views the sourcing industry. Conversely, it is important to understand the challenges and opportunities this sector has in terms of leveraging global capabilities. This paper responds to this very question.

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Facets of the Mid-Market Sector

Tremendous opportunity exists today for midsize companies to expand, innovate and assume a leadership role in the global economy. Midsize companies have a myriad of new, cost-effective business and technological capabilities available to them. Any company with a great idea, sufficient Internet bandwidth and a reasonable amount of capital can compete, grow and reach new customers in its local market or around the globe. Competitive advantage is based increasingly on innovation, speed to market and knowledge, rather than size and scale. Realizing this, midsize companies across the globe are seeking to adapt their business models to market shifts and customer needs. These companies also intend to integrate technology both to run their businesses more efficiently and also to change their businesses in order to adapt and grow.

But how far along are these companies? Are they confident in the state of their core operations? Are they looking ahead to see what capabilities can help their businesses adapt and expand in the near term? Are there specific strategic initiatives they can adopt to remain ahead of their competition, while enhancing their capabilities sufficiently to take on the opportunities offered by globalization?

A recent survey of leaders spanning three continents revealed a surprising consistency in what mid-market CEOs view their challenges to be – growth, expansion and profitability. In the context of growth, organic strategies are seemingly no longer able to provide organizations with the lever required to stay ahead of competition [before commoditization catches up]. This in turn impacts expansion initiatives and hence profitability. Consequently, soliciting private capital to fund such initiatives and sustain commoditization pressures has been on the increase. However the funding sources have realized less than expected returns, resulting in their reluctance to fund expansion-related initiatives of the mid-market sector. So, has this market come round a full-circle?

One of the biggest challenges that mid-market organizations are facing - as recently revealed in a study of this sector concluded by IBM – is the increasing level of sophistication from their customers, thereby requiring organizations to look at innovative ways to enhance customer experience. Adding to the pressure is the need to enhance operational efficiencies.

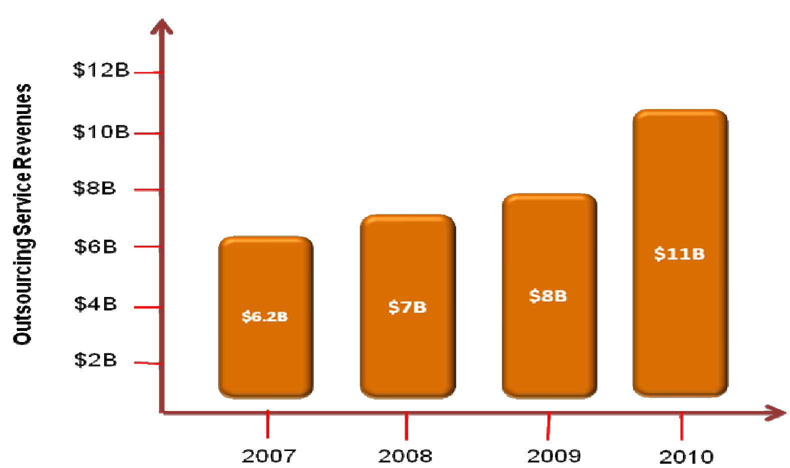
Focus on operational efficiencies has now transformed itself from hitherto being a divisional/ departmental issue to a corporate issue, where Boards are exploring new ways of bringing in much-needed efficiencies that contribute directly to the product development teams, as also supporting expansion ventures aimed at creating new lines of business. This in turn is now pushing organizations to review the business models as traditional models are failing to contribute to revenue-growth.

Non-traditional competition coupled with global market forces is pushing the envelope on organizations, forcing them to centralize their services and build strategic partnerships. For most midsize companies, these business model changes represent expansion – whether it's local, regional or global. These various tiers of expansion are supported both by new lines of business and strategic partnerships for going to market. Centralized services across multiple locations are also among the top business model modifications. From internal services like payroll and human resources (HR) to customer support such as helpdesk lines, centralization is gaining momentum.

Opportunities to Leverage Global Sourcing

Responding to the challenges and opportunities of the global marketplace is as much about new business models and growth strategies as it is about operational efficiency. At a fundamental level, growth, innovation and serving customers better all come down to core operations. So, little wonder that, across most industries, information technology infrastructure security and reliability are among the top two operational investment areas. Most decision makers agree with their industry peers on the key focus areas for operational efficiency, but they lack confidence in the completeness of their current capabilities.

These are the thousands of small and medium enterprises that are increasingly waking up to cash in on the outsourcing wave, a market opportunity explored by their big daddies for a couple of decades now. "SMEs in the US are under severe pressure to increase profitability and business margins. This will force them to outsource and even have M&A arrangements with Indian firms. India is going to be a great beneficiary of this trend. This will substantially offset or minimize the impact of the US recession on Indian industry," said Adam Larkey, partner at Wolet Capital Corporation, a New York-based investment banking firm. The demand spur has begun to take shape especially in the past two years, and the trend is surely to continue given the slump in the US economy and associated issues resulting from the credit crunch. This will only push smaller and mid-sized firms further to the corner, making them ready and willing embracers of the global sourcing model. The trend is expected to provide significant growth prospects, as under.



The total outsourcing from the US by 2010 is expected to be whooping $54 Billion. Again, reinforcing this trend is the fact that the mid-market sector today accounts for 80% of the US industry in terms of volume, with over 20,000 small and medium firms in the revenue bracket of $2 Million to $500 Million; 6,000 companies in the $500 Million to $2 Billion bracket and another 3,000 in the $2 Billion to $5 Billion category [while 2,000 firms with revenues of $5 billion and another 1,400 companies in the $5 billion to $10 billion bracket comprise the larger companies]. These organizations are expected to drive the adoption of global sourcing models, concurrently learning from the mistakes and experiences of the larger firms, thereby bringing in additional business and financial model ingenuity.

As revealed from IBM's study, for midsize banks, more than 76% of executives agree that IT infrastructure security and reliability are keys to protecting financial transactions and customer data. But less than 30% are confident that their current capabilities in this area are complete. At the same time, less than 30% are building the appropriate capabilities. A similar trend in IT security can be seen in retail and healthcare where the security of customer and patient information and identity is paramount. Outside the retail and banking industries, midsize wholesalers have a gap of their own in the core operational area of supply chain management. Critically dependent on the transparent and accurate flow of goods, parts and merchandise, 78% of wholesale industry executives agree that supply chain management capabilities are one of their top imperatives. Even so, only 16% are confident that their current capabilities are complete. And only 22% are currently building effective information technology capabilities for their supply chains. Given these inherent challenges, competitiveness is no longer viewed as getting things done faster and better. Today competitive advantage stems from the ability of mid-sized organizations to become [and remain] innovative, increase speed to market, and continually enhance internal knowledge. All these factors are putting increasing pressure on the most vital resources of all – human resources.

The key transformation being pursued with this resources is to enable them become drivers of business intelligence and customer relationship management, such that they become the initiators of change within the organizations where customer interactions and proximity are propelled to a level where customer loyalty becomes a permanent performance measure. Consequently, a significant amount of time and effort is being invested in enhancing employee productivity through adoption of pervasive communication strategies. However in order to focus on what matters the most, organizations need to flex their rigid business models principally by engaging in strategic partnerships with organizations that have specific core competencies, which can be leveraged to create a nimble organization. In this context, sourcing talent and capabilities from the global marketplace is now a foregone reality. Furthermore, the focus for such partnerships has to be exactly that – partnerships. Replicating the fee-based business relationships [across outsourcing and global sourcing engagements] of the larger companies can lead to a sure-shot disaster since in most such engagements vendors are not oriented at enabling their customer organizations; rather the focus is restricted to achieving cost-objectives alone.

POTENTIAL BENEFITS FROM ADOPTING OUTSOURCING

Access Latest Technology at Lower Costs: Typically midmarket organizations do not have enough financial bandwidth to deploy latest solutions and human resources to support their G&A needs. Leveraging a service provider's capabilities across both business and technology functions [where most providers underpin their business services with technology platforms] becomes a key advantage. This in turn results in a direct net reduction in the total cost of outsourcing [and consequently to the G&A costs].

Opportunity to Reduce Operational Costs: Tremendous opportunity exists to reduce current operational costs, while concurrently increasing efficiencies by outsourcing business processes and technology functions to a third-party service provider. Typical target business processes include G&A functions like Finance and Accounting, Human Resources and procurement. Other G&A functions include customer care services, logistics and industry-specific services [like insurance claims processing, mortgage processing etc]. Typical target technology functions include Infrastructure Security, Knowledge Systems, Application Development & Maintenance, Technical Helpdesks, and Managed Services. A significant downsizing of G&A function through labor arbitrage contributes well to the corporate balance-sheet.

Getting Rid of Licensing Straitjackets: Given the inherent nature of the delivery model – across both business and technology services – that service providers bring to the table, most mid-market organizations can reduce their financial allocations for technology licenses significantly, as service providers carry such costs within their pricing structures. Since their service pricing is inclusive of not just core performance for resources allocated, but also builds in efficiency enhancements, the total unit cost for such services is lower by at least 25% to 30%. This form of service is typically enabled through deployment of "software-as-a-service" delivery model.

Increased Business Focus of the Retained Organization: Adopting outsourcing services providers for non-core activities releases existing employees to focus on more strategic and decision-oriented roles where analysis, evaluations and customer orientation takes a front-seat. Such flexibility is much needed given the inherent nature of businesses to become commoditized very quickly. At an operational level, one can see direct benefits since the retained employees are focusing on evaluating, analyzing, interpreting and taking decisions from data that is gathered and generated by the service provider, instead of doing it themselves.

More Fulfilling Career Paths: Outsourcing is not about losing jobs. On the contrary it can provide more fulfilling career paths for professionals hitherto tied in to G&A roles that are mundane. An ability to directly contribute to their organizations' growth and innovation-potential is seen as a major fillip in an increasingly complex global marketplace.

CHALLENGES

Lack of Readiness: Most mid-sized firms are in a poor state of readiness to embrace new business models like outsourcing. Further compounding effect is seen with offshoring brought into the equation. This readiness clearly points out to the lack of awareness of outsourcing and its intricacies at the strategic management level.

Rigidity with Traditional Models: Many mid-sized firms are either closely-held organizations, or family-run businesses. Such restricted ownership models contribute an added challenge to the mindset within the leadership, translating to rigidity in adopting appropriate "partner-oriented" business models.

Bottom-line Driven: Most mid-sized organizations tend to spend most of their management time focusing on the bottom-line [profits] while service/ product offerings are increasingly commoditized, thereby inhibiting top line growth [revenue]. This in turn puts significant pressure on profit margins, leading to inordinate/ unstructured cost cutting measures. Resultant impact of such cost-cutting measures is loss of existing talent, inability to bring in new competencies/ enhance existing competencies. Operational efficiencies too suffer as a result of resource scarcity.

Lack of Strategic Vision: Given dwindling margins in a commoditized environment, top management spends more time focusing on operations resulting in no effort being invested in creating either mid to long term strategies aimed at transforming into a competitive non-commoditized entity. This in turn reflects in inconsistencies within Boards to focus on what matters most – growth and competition.

Capital Crunch: Inability to raise capital, resulting from the above, leads to further financial squeeze. Therefore focus on internal R&D is put on the back-burner, creating a situation of an inward spiraling of issues until the firm's size reduces to the extent that it is no longer able to raise private capital even through sale of significant portion of equity.

Lack of Strategic Management Competence: Inability to bring in competent management in the absence is further compounded by a continual churn within existing management. This has down-stream impacts reflected in lackluster leadership, inconsistent understanding of the business focus, resulting in poorly implemented business strategies. Promoters in such instances are therefore focused more on exiting rather than growing the firm, and pursue multiple objectives – selling/ hiving the firm, divestiture/s, equity dole-outs, buyouts etc.

Assume IT Solutions Alone Will Transform Businesses: Most CxOs in this sector assume that bringing in latest technologies alone will enable transformation of the company. Owing to smaller spend capabilities, more often than not they end up bringing in off-the-shelf applications, and try integrating multiple technologies using poorly trained internal IT teams. This is seen primarily in the increasing marketplace for IT staff augmentation [which is today a roaring business in the US]. Such augmentation efforts at best bring in discrete technical capabilities, but concurrently impede the organization further in its ability to integrate its business with technology/s being deployed. Hence IT spends do not often result in bottomline increases or reduction in time-to-market products/ services. More importantly, the learning curve the organization goes through during such implementations often results in a serious erosion of existing operational efficiencies.

CONCLUSION

The opportunity to leverage global sourcing as a business driver and tap into capabilities beyond domestic borders is significant. However there is also an intrinsic learning curve for mid-market organizations as they commence exploring strategic partnerships with capable entities from across the borders. Crucial as the challenges are, and compelling as the opportunities are, mid-market organizations would do well to initiate serious steps at adopting outsourcing/ global sourcing as a key strategic business driver in order to remain ahead of the commoditized curve. Leveraging capabilities of firms that understand the sector and its key players is a recommended way forward so as to learn from successes while ensuring the retained organization transforms itself to a nimble and innovative one.

Prudence is necessary for mid-market organizations embracing this opportunity. Targeting low-hanging fruit would be a most-appropriate approach towards enabling a learning experience for the organization, and where direct cost-savings and demonstrated process efficiencies can be achieved. Armed with this experience, organizations could then better prepare themselves for developing partnership-oriented models where the key capabilities of service providers could be leveraged, especially when existing proven solutions with slight modifications [to suit an organization's particular nature of business] become more pertinent solutions to existing issues. In such cases the experience of service providers becomes invaluable, as they bring specific solutions to the table, and not just deliver upon services at lower costs.

Matryzel Consulting is an independent strategic consulting, services sourcing and advisory firm specializing in practices that have a direct influence on the services globalization industry.

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