

THE FUTURE OF Deal Structures

Shorter Deals and Outcome-based Pricing

DAVID BROWN

Director, Financial Architecture, EquaTerra

They say that in the year 2010 astronauts from multiple countries will research the cosmos from the comfort of a newly completed International Space Station, while support staff back on earth will direct them using a new Microsoft operating system called Windows 7. But the global sophistication of the future doesn't stop at spacecraft and software. Business the world over is getting savvier — and that also goes for outsourcing, as market trends today portend some notable shifts in IT and Business Process Outsourcing (BPO) deal structures for 2010.

Though some of today's deals are becoming more global in reach, they're also starting out smaller in scope, spanning fewer years and being priced based more on outcome than volume. Emerging deal trends such as these — along with ongoing demand as new deals are signed and old ones renewed — connote a marketplace that's becoming better educated.

Let's take a closer look.

PRICING

As outsourcing matures, customers are increasingly looking for more than transactional cost savings and service improvements. They are looking for broader business impact and value from their outsourcing relationships. Pricing models are following suit toward more outcome-based pricing. For example, rather than paying for a certain number of receivables processed, CFOs might rather pay for an overall reduction in receivables past due and the corresponding cash-flow improvement.

In HR and IT outsourcing, likewise, companies increasingly want to tie their outsourcing deals to organizational goals, such as reducing the cost per active employee or reducing IT spend as a percentage of revenue. In the not too distant future, more sophisticated outcome-based pricing may be tied to productivity improvements due to a service provider's analytical support, or on reduced employee

downtime due to improved HR processes for managing leaves and absence.

Holding service providers accountable to such end-to-end outcomes does have limitations, since a reduction in receivables past due, for instance, may not immediately be within a provider's full control. However, as deals mature and providers demonstrate their broader capability, while customers build trust, outcome-based pricing may become standard by 2010.

A related pricing trend is customers' growing desire for milestone payments during the services transition period. Instead of paying service providers monthly, some organizations prefer to pay upon achievement of certain goals, such as the timely completion of knowledge transfer or hiring. Milestone payments are an emerging standard for ensuring that a deal stays true to its projected timeline.

Customers are also considering add-on possibilities as part of pricing negotiations. Say an organization wants to outsource invoice processing and bank-account reconciliation now and, once it has confidence in the service provider, hand off its financial reporting later. The parties may build pricing into the contract for this projected work.

SCOPE, LENGTH AND RENEWALS

The issue of trust between customer and provider is also driving trends in deal scope. Instead of the mega deals of several years back, companies are trending to initially outsource some back-office functions, and possibly expand the scope down the road after gaining confidence in and a strong relationship with the provider. Deals may also include a pilot, enabling parties to test the outsourcing of a process in one region for possible expansion to others.

BPO deals are spanning fewer years, decreasing from an average of seven to five. Except for those deals with large-scale transformation, this is enough time for most providers to recover their investment while customers achieve improvements and enjoy a couple of years of steady-state operations. Another trend is increased deal renewals, along with more renegotiations of contracts prior to expiration. Fewer years and more renewals are favorable signs, showing that outsourcing relationships are working.

GROWING DEMAND

Organizations' improved outsourcing savvy befits a market that's growing and reshaping. According to an EquaTerra study conducted Apr. through June 2007, outsourcing demand was up 37 percent globally and 50 percent in Europe, Middle East and Africa (EMEA). IT outsourcing was especially strong in EMEA, which was home to 60 percent of the publicly announced deals greater than \$50 million in total contract value.

In addition, European outsourcing deals are becoming more global. Traditionally, a European multinational corporation may have had individual outsourcing relationships in five or six different countries, compared with the typical U.S. multinational that has one outsourcing deal across several geographies. But now, European deals are becoming less geographically divisional and a global delivery model may be standard in 2010.

That trend is supported by ongoing growth in the multilocation delivery capabilities of service providers. Some offshore providers are expanding their capabilities by adding nearshore locations, enabling them to better compete with multinational providers. Meanwhile, some of those larger providers are buying and developing offshore operations to achieve more worldwide scale. This expanding and diversifying provider base should result in more integrated solutions and greater choices for customers.

In conclusion, as new deals are signed and old ones renewed amid the growth of global delivery, outsourcing demand is robust. And that demand, coupled with customers' increased education and experience in outsourcing, is leading to new kinds of outsourcing initiatives, as organizations structure deals that are more meaningful to management.

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David directs EquaTerra's financial-architecture practice, and has more than 20 years of experience in the space of ITO, BPO, sourcing management, contract renegotiations and finance budgeting, planning and analysis. His industry experience is primarily in the communications, transportation, energy, retail and publication industries. Before joining EquaTerra, David was a senior advisor at TPI.



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