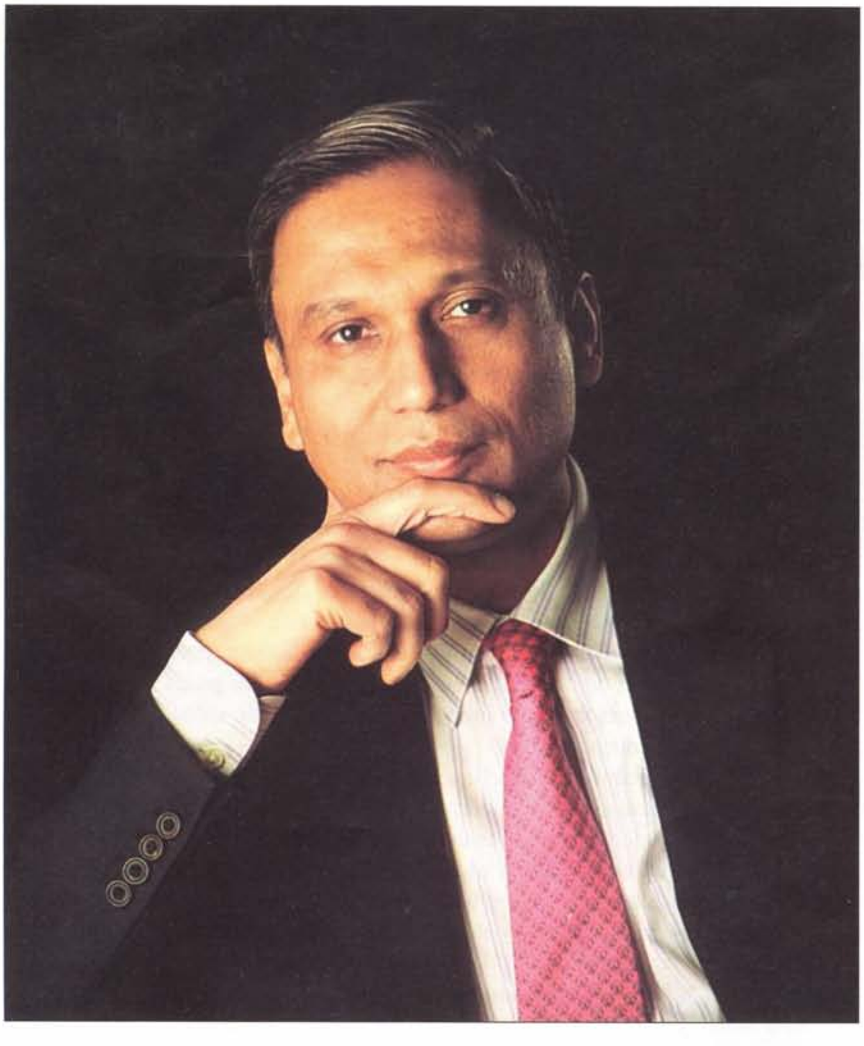
Dynamic Alliances in 2007

By Myra A. Thomas

The year included hot M&A deals, key partnerships, and 'near-shoring' moves by major players in the sector.



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Taking a look back at 2007, the year represented a hallmark period for the business process outsourcing industry. It was a year of consolidation for the financial services outsourcing sector, as larger and broad-based operations and private equity players snapped up sizeable and smaller and more-specialized vendors. The deals signaled the value and maturity of this space, as well as the inevitable M&A trends inherent in any industry.

Of course, along with that maturity come worries that there will be an inevitable drop in the M&A momentum and a decline in the recent momentum in sales increases at the BPO firms. Now, business process outsourcing players and Wall Street analysts are wondering if the explosive growth can continue in the sector, especially as it ages and as the economic environment in the United States, one of the largest markets for those services, is slowing.

For now, M&A activity in the sector indicates the health and vitality of the marketplace. This issue features an in-depth FSO Knowledge Xchange research report on the biggest M&A deals occurring in January 2007 to September 2007. The two major deals identified here represent some of the best and brightest in the financial services and BPO spaces.

A CLOSER LOOK AT TOP M&A DEALS

The FSOkx research team identified private equity firm Kohlberg Kravis Roberts & Company's (KKR) $25.6 billion purchase of First Data as the largest M&A in the period and as one of the largest LBO deals. First Data's stockholders will receive $34 per share in cash. Under private ownership, First Data's common stock will no longer be listed on the NYSE. A KKR-affiliated company completed the acquisition in September 2007.

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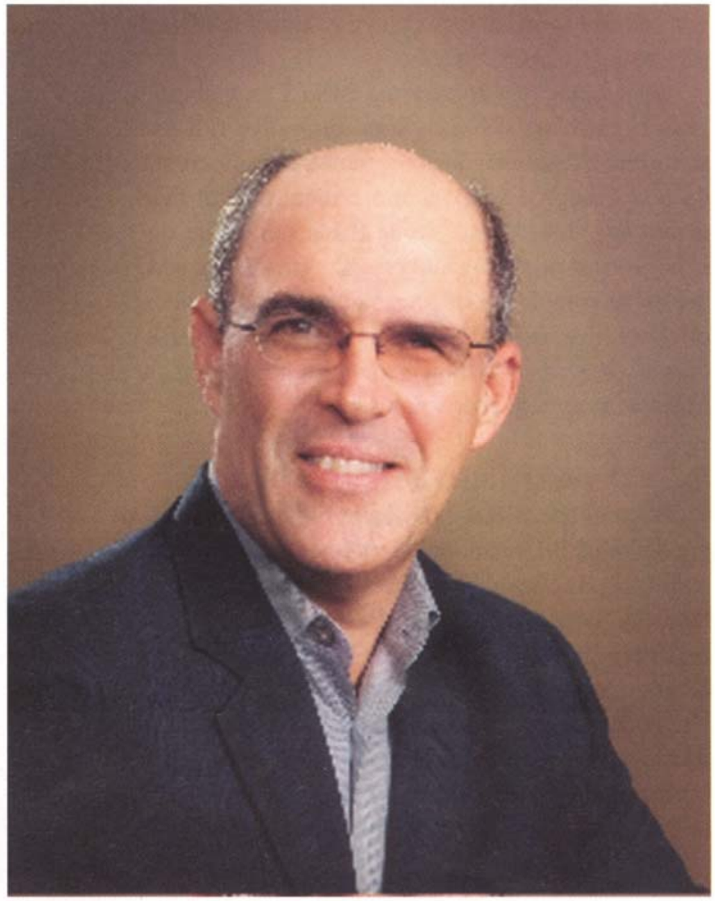
According to company spokesperson Nancy Etheredge at First Data, the electronic commerce and payment solutions provider's strong, predictable cash flows and an experienced senior management team made it an attractive portfolio company for KKR. Today, First Data is expanding its global operations in electronic payments, and the link-up with the deep pockets of private equity player KKR provides the company with access to cash to continue its investments into additional products and services.

Etheredge notes that First Data is now looking to focus on product development, extend its relationship with key customers, and opt for organic growth versus acquisitions. The intention appears to be to change First Data from one of the largest payments processors to accommodate the quickly growing world of electronic and mobile commerce. Etheredge adds that "as consumers continue to move toward electronic payments and away from cash, we are committed to investing in technology and product innovation to enable our customers to take advantage of this cashless revolution."



Michael Capellas became First Data's chairman/CEO after the acquisition of First Data by an affiliate of Kohlberg Kravis Roberts & Company (KKR) in September 2007.

The FSOkx researchers also identified a key M&A play by the top financial services company Citi. In August, Citi purchased BISYS Group for $1.4 billion, making it the third largest M&A in the period. As of August 2007, the investment services division of BISYS Group was acquired by and is now a member of Citi. As of the same date, the retirement and insurance services divisions of BISYS Group were combined with and sold off to Crump Insurance Services to form a new company—Crump Group.

According to Neeraj Sahai, managing director/global head of Securities and Fund Services at Citi, BISYS was an attractive acquisition due to the company's "industry leading capabilities in the mutual fund, hedge fund, and private equity administration areas." The marriage of the two companies creates a significant presence in the investment sector, and Sahai acknowledges "the acquisition positions us as a top-tier provider in the investment servicing industry and provides a broader base of talent and expertise to Citi clients." The acquisition also enables Citi to deliver a comprehensive portfolio of administrative capabilities with sizeable scale and scope to the mutual fund, hedge fund, and private equity marketplace.

Says Sahai, "By integrating BISYS's capabilities with Citi's global reach, we've created an innovative full-service product suite that extends far beyond transaction processing to include deep operational support and critical capital market services across the globe." And, while Sahai notes that the BPO space is dependent on M&A and organic growth, he adds that "given the rising complexity of financial markets, including the growth of alternative asset classes, my view is that M&A activity that delivers benefits based on economies of scope is far superior to M&A activity that is driven by scale."

PARTNERSHIPS MOVE INNOVATION

Beyond the M&A landscape, other critical deals and key partnerships indicated the overall health of the BPO space with major players continuing to drive IT innovation. In October, Nokia Siemens Networks and Wipro Technologies, the global IT services company based in Bangalore, India, agreed to the terms and conditions of a business transfer and asset sale of Nokia Siemens Networks radio access-related R&D activities in Berlin. All Radio Access R&D activities currently performed in Berlin will be provided to Nokia Siemens Networks by Wipro Technologies in the future. Through this agreement, Nokia Siemens Networks will leverage Wipro Technologies' global expertise as one of the largest independent R&D services providers in the world.

Another partnership between Hewlett-Packard and Computational Research Laboratories (CRL), a wholly owned subsidiary of Tata Sons Ltd, is pushing the envelope on the speed of supercomputers. The supercomputer facility at Computational Research Laboratories was recently ranked as the fourth fastest supercomputer in the world and fastest supercomputer in Asia, according to the Top500 Supercomputer list announced at SC07, the International Conference for High Performance Computing, Networking, Storage and Analysis held in Reno, Nevada.

Called "EKA," the Sanskrit name for "number one," the supercomputer built at the CRL facility at Pune, India, uses dense data center layout and novel network routing and parallel processing library technologies developed by CRL scientists. The CRL supercomputer was built using CLOS Architecture with off-the-shelf servers and Infiniband Interconnect technologies and Linux as the operating system. This is the first ever site in the world using Dual Data Rate Infiniband with fiber-optic cable technology for superior performance. The CRL supercomputer includes nodes and racks built by Hewlett Packard (HP Cluster Platform 3000 BL460c system), which uses high-speed quad-core Clovertown processors from Intel Corp. and Dual Data Rate Infiniband switches from Mellanox Corp. and Voltaire Corp. Scientists and engineers at Tata Consultancy Services, the global IT services provider based in Mumbai, India, actively supported the CRL team.

For now, CRL is targeting and developing applications such as neural simulation, molecular simulation, computational fluid dynamics, crash simulation, and digital media animation and rendering. The longer-term application areas would include financial modeling, seismic modeling, geophysical signal processing, weather prediction, medical imaging, nanotechnology, personalized drug discovery, real-time rendering, and virtual worlds among others. CRL also intends to offer high performance and supercomputer system integration, research, applications, and software services in the area of high-performance computing.

UNDERSTANDING THE LANDSCAPE

Of course, getting a sense of the players also requires an understanding of how the geographic landscape is shaping up for BPO players in the BFSI (banking, financial services, and insurance) space. The innovative plays of Wipro and Tata noted indicate R&D growth for the BPO space. But, just where will the powerhouse of BPO be tomorrow, and where will companies go for a talented labor pool able to service higher-end financial services players?

Today, Poland, Belarus, Costa Rica, Mexico, Australia, the Philippines, and other countries are looking to grow their outsourcing business to compete with the major players in India and China. India remains the key market in size and expertise for business process outsourcing, and especially for the types of higher-end services geared to banking, insurance, and the capital markets, and experts note that this lead in sourcing shouldn't dissipate any time soon. Andrew Wasser, associate dean in Graduate Information Systems Management programs at Carnegie Mellon University, adds, "India's strength in IT-based sourcing is stickier than you might think. Firms are not going to easily move their captive or vendor operations to Vietnam or Poland because of fluctuations with the rupee."

Wasser notes that India has a number of long-term, sustainable advantages over other countries when it comes to IT sourcing, including: (1) mature vendors and processes; (2) a community of IT professionals; (3) English proficiency with the majority of the population; and (4) culture and education. He adds, "IT development and support is not focused on labor costs. Firms focus on risk reduction (infrastructure and government stability), availability of talent, quality of delivery, etc. I am less comfortable making this same pronouncement for lower-end BPO work, but for IT, India will be the lead sourcing country for some time to come."

"NEAR-SHORING" GAINS GROUND

The growth of the Indian BPO marketplace continues to offer opportunities far beyond the reach of the country, as the leading players target North American "near-shoring" opportunities to service their U.S. client base. Adding to the near-shoring phenomenon, Hexaware Technologies, a global provider of IT and BPO services based in Mumbai, India, inaugurated a new near-shore facility in Saltillo, Mexico, in October. The operation is the company's second center in the country. Hexaware launched its operations in Saltillo, Mexico, with the acquisition of FocusFrame in 2006. FocusFrame, a specialized testing services firm, has over 100 employees located at the development center in Saltillo.

Besides the centers in Mexico, Hexaware also has global delivery centers in Mumbai, Chennai, Pune, and Delhi in India and Bad Homburg in Germany. In a statement, Atul Nishar, founder and chairman of Hexaware Technologies, notes, "With beneficial factors like proximity, as well as the same time zone as North America, we believe that the Saltillo Center will give us the ability to serve the U.S. and Canadian market with greater efficiency." The Saltillo center will provide software development, application, and maintenance work.

Other newer competitors are looking to capitalize on the near-shore market. Enrique Ramos O'Reilly, CEO of PotentiaN, an IT solutions provider with offices in Florida and Mexico, notes, "Near-shore locations, like Central America, will have a competitive edge over lower-cost-but-farther-away locations in India and China. We believe that the focus in 2008 will be on productivity and not on labor savings, using syndicated development models where the skills between on-site and off-site work are complementary. For this to work, you need a higher level of interaction between client and the outsourcing entity—people working on similar time zones and within geographical proximity to enable face-to-face contact."

THE BUSINESS TRANSFORMATION TREND

There is also another shift on the horizon, notes Wasser, as key players in the BPO space look to offer more specialized and even higher-end services to respond to the rapidly changing business dynamic. "They all claim that business transformation is the direction they are heading in with their new client deals." He identifies business transformation as a trend with four key components, including:

- **Risk Sharing**

This includes outcome-based pricing, revenue/savings sharing, incentive structures, etc. Essentially, organizations are using principle-agent theory to better align client goals with service provider goals.

- **Traditional Reengineering**

This involves using outsourcing as a catalyst for platform and process streamlining. For those looking to institute an outsourcing model, this disruptive process is a good time to improve on operations.

- **Comprehensive Outsourcing**

As firms get more experience with outsourcing their services, they are gaining the confidence to move larger chunks of their operation (IT, infrastructure, BPO) to a vendor. Basically, this is outsourcing with more breadth and depth, signaling a successful and growing partnership with the vendor.

- **Knowledge Based Sourcing**

As firms outsource R&D and other high-end functions, it fundamentally changes the fabric of the client's internal organization. Service providers moving up the food chain are doing higher-end work, using the "business transformation" term to differentiate their activities from the more mundane outsourcing of operations.

Wasser adds that financial services firms are highly engaged in each of these four sourcing trends. "Since financial services firms were one of the early adopters of global sourcing, it is not surprising that they are in a position to lead the new industry trends," he adds.

Offering "value" and not merely "cost-savings" will be key in 2008, says Enrique Ramos O'Reilly, CEO of Potentian. "Projects will be run more on collaborative models rather than just an outsourcing one." He terms this model as "knowledge arbitrage," signaling the industry's move to more relationship-oriented transactions.

THE INDUSTRY PERSPECTIVE

Of course, the changing relationship dynamic, as well as price pressures from the troubled housing sector, means that much more consideration will go into the BPO decision making process for financial services firms. Jess Varghese, managing partner of Milestone a global management consulting firm, says, "The biggest observation that we have seen is that clients don't rush into these deals anymore, and there's a lot more modeling. Clients are taking more time in due diligence and planning." But even this seemingly negative trend is resulting in more consulting opportunities for those on the modeling end of the business. Says Varghese, "Firms are looking for more analysis upfront to get a detailed view on processes and sub-processes."

Another key trend in the financial services outsourcing market is the targeting of other key geographic markets—those outside of the U.S. As the American space matures, BPO players understand the need to amp up growth by expanding the reach of services.

Jonathan Clark, global CEO for Citisoft, an investment management consultancy, says that his company is seeing more globalization in their client base, with firms moving toward a centralized platform, processes and a shared service model. In his sector, he says the trend is starting with the "lowest hanging fruit," or in this case, reconciliation. Today, Citisoft has a client base of more than 75 percent of the top 50 global asset managers, with the firm supplying strategic planning and implementation services to the institutional and wealth management sectors. Clark operates from company offices in London, England, but the firm also has U.S. offices.

But even as capabilities and opportunities grow outside of India, the main base of operations and innovation remain there for many firms, including Citisoft. Clark adds, "We're creating an investment focused pool of resources in India. We have business analysis to tech services there, and tons of capable people delivering application development, maintenance, testing and support. It's end-to-end service."❑