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Outsourcing Pricing: Do You Know What You Don't Know?

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Live Tweeting #EGAnalyst

Introductions

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Context setting

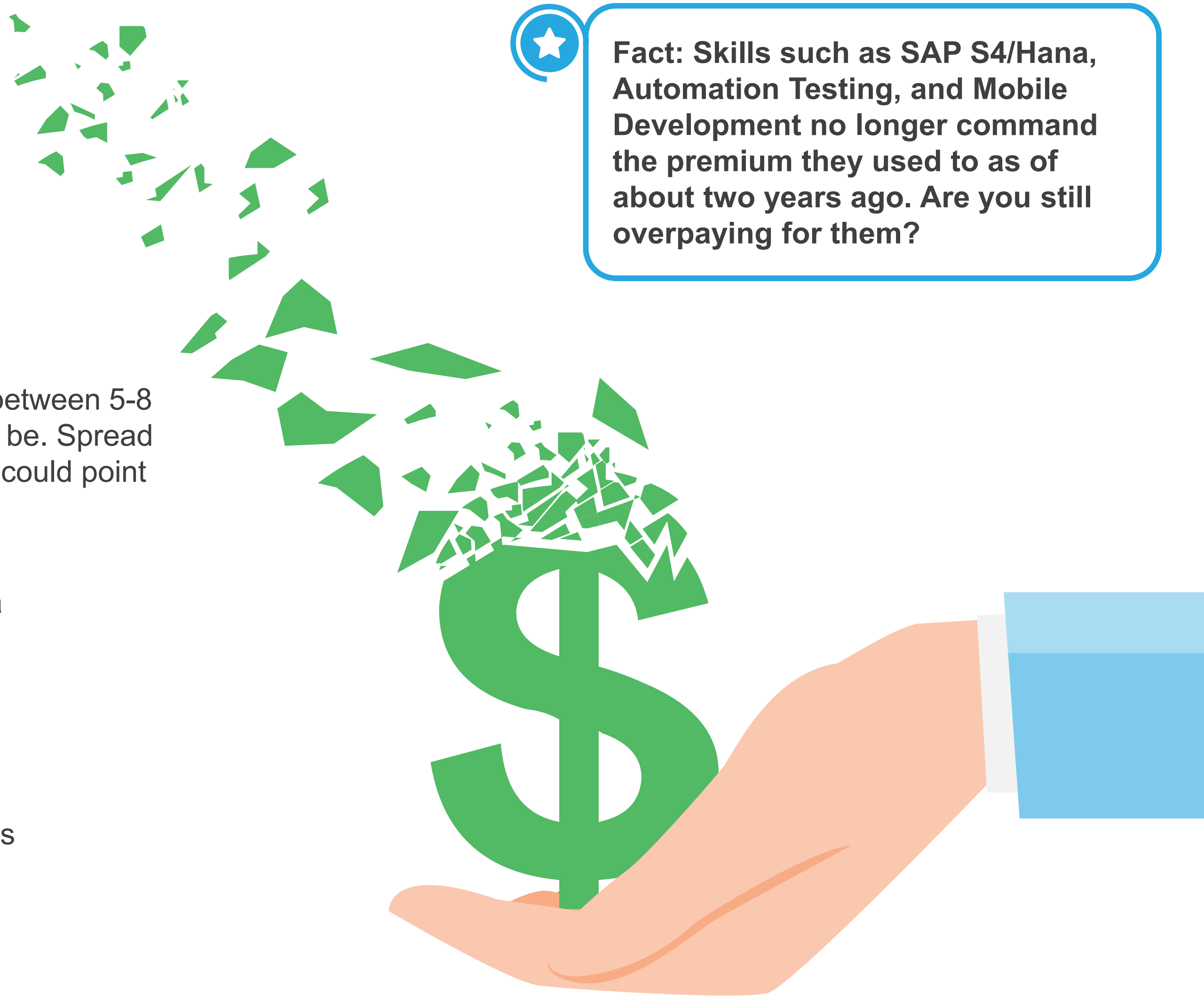
Focus of this webinar

- What are some current pricing trends impacting enterprises and providers?
- What type of pricing movement can be expected in the near-term?
- What direction are outsourcing contract tenets moving?

Sources for today's webinar

- Everest Group's recent sole-sourced and competitive deal advisory experience
- Perspectives from recent mid-tenure contract and strategic engagement reviews
- Discussions with multiple enterprise strategic outsourcing stakeholders

Why should we care about pricing?



Fact: Skills such as SAP S4/Hana, Automation Testing, and Mobile Development no longer command the premium they used to as of about two years ago. Are you still overpaying for them?

- The premium has dropped anywhere between 5-8 percentage points from what it used to be. Spread across a large number of resources, it could point to significant value leakage
- For example:
  - SAP S/4 HANA premium over Java is down by 7-8 percentage points
  - Automation testing premium over Manual testing is now down by 5-6 percentage points
  - Mobile development premium over Java down by 5-7 percentage points

Discussion points for today

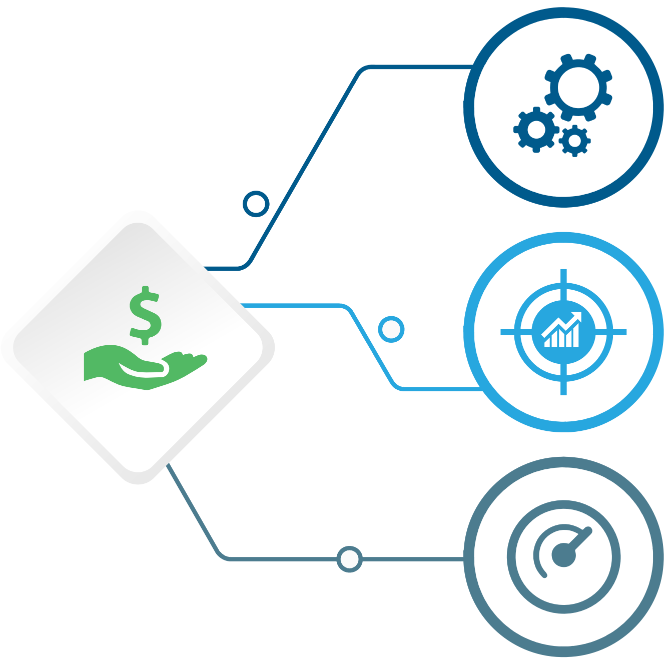
Pricing models are changing, but not as one block

Expected near-term pricing movement

Evolution of contracting tenets

Q&A

Some fundamental definitions



Output-based pricing means a pricing model where the fee is linked to the output of a certain service or process.	For example, the price per application support ticket, price per device managed, or price per invoice processed.
Outcome-based pricing means a pricing model where the fee is linked to an actual business outcome.	For example, fee for procurement strategic sourcing and category management, which is linked to the committed savings achieved.
In contrast, **input-based pricing** is where the fee is linked to the time or effort delivered by the resource.	For example, a rate per hour for a developer resource.

At a macro level (across deal types) are showing a clear intention to move from input-based pricing to outcome- and output-based pricing

Increasing adoption trend | Static adoption trend | Decreasing adoption trend

	Percentage of spend based on respective pricing model for IT Applications		Percentage of spend based on respective pricing model for BPO	
	Past 2-3 years	Next 2-3 years	Past 2-3 years	Next 2-3 years
Fixed price and other	27% ↓	23%	18% ↓	15%
Outcome-based	18% ↑	26%	22% ↑	30%
Output-based	22% ↑	27%	32% ↑	34%
Input-based	33% ↓	24%	28% ↓	21%

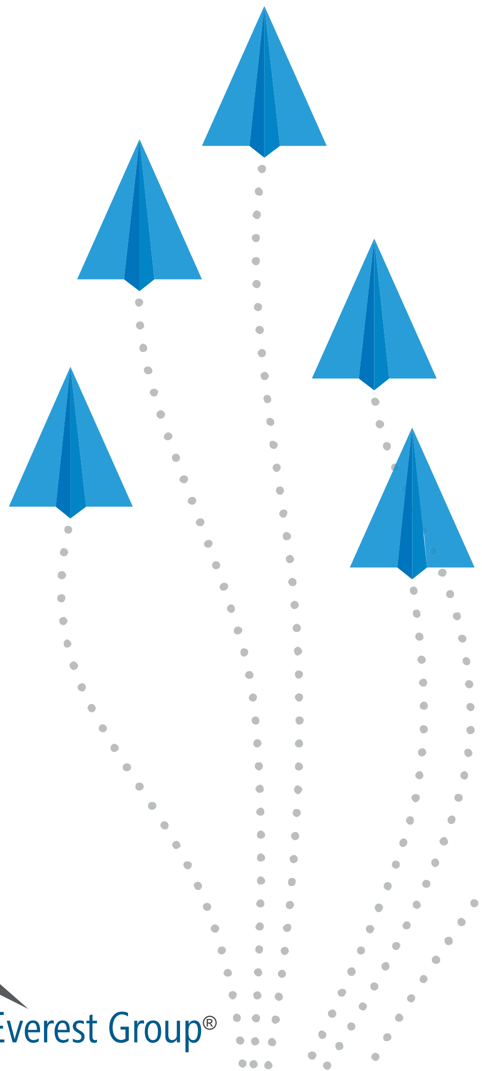
Source: Everest Group's Trends in Outsourcing Pricing Survey (2018)

However, on Digital-focused deals (mostly Agile delivery) we are seeing more of T&M and Managed Capacity sequentially moving to fixed fee and output based

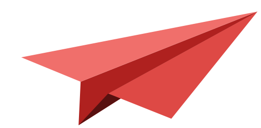
Typical sequence observed

Time & Material	With no direct visibility into the end product, enterprises start with a Time & Material model
Managed Capacity	As some visibility and experience/ ways of working develop, both parties typically move into a Managed Capacity model which ensures a certain cap on hours charged
Fixed Fee	The next stage is when a repository/library of precedents has been created to enable fixed fee pricing *(without baking in excessive risk premiums)*
Output-based	In some mature relationships, the model has evolved to a *"per story point developed"*, but as expected it takes ample normalization to define and price a story point is in that context

Make no mistake, it is the enterprise that will have to push through some of these pricing model changes to realize high impact in the face of neutral to low levels of proactiveness from service providers



- This may appear counter-intuitive, but the maximum impact is seen in cases where the service provider was change resistant or minimally proactive
- Service providers have a tendency to protect their revenue streams, so wherever the potential “size of the prize” is large, they will be change resistant
- Eventually, it is up to the client enterprise to drive the change in pricing models



Discussion points for today

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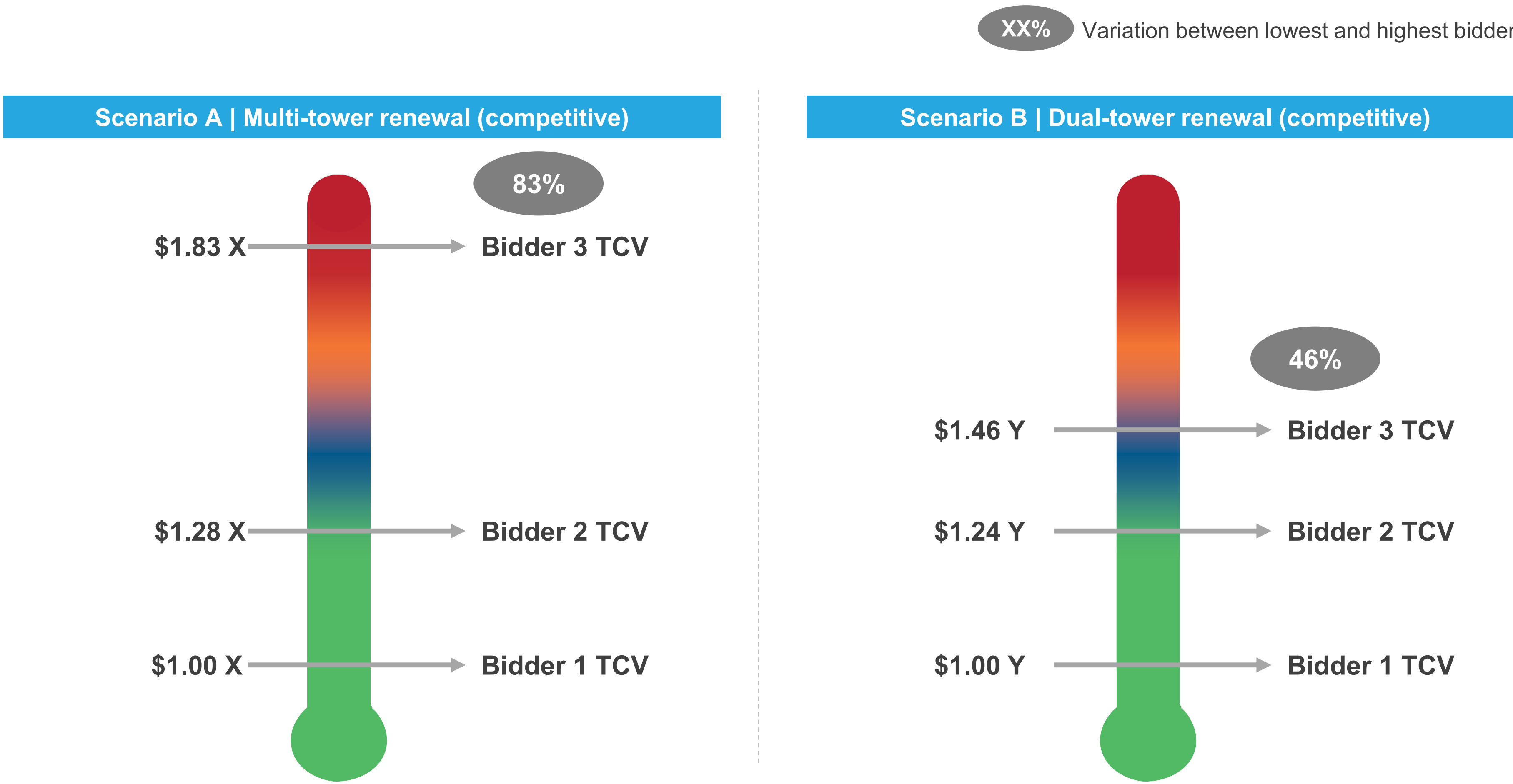
Quick Poll #1
How much do you believe the maximum variance between competing bids on an infrastructure deal to typically be?

- **<21%**
- **21-30%**
- **31-40%**
- **41-50%**
- **>50%**

We are seeing significant variance in IT Infrastructure deal pricing, which is expected to continue as delivery models evolve

Anonymized indexed pricing (Total Contract Value) from two IT Infrastructure deal scenarios



What could be causing this variance?

Skewed assumptions: Taking the most conservative assumption (offshore ratios, dedicated resources, etc.) often tends to bloat the overall price

Over-solutioning: Providers may over-solution and include a complex transformation solution which may not have been asked for by the client

Tools and technology: The committed financial impact from automation and other tools could cause material variation in the overall fee

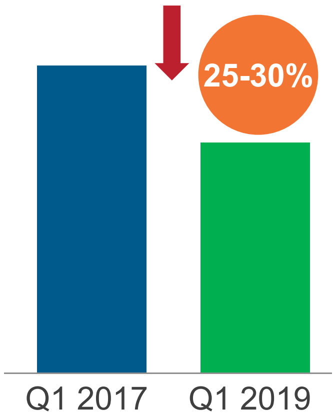
High degree of variation in deal pricing

Why should we care about pricing?

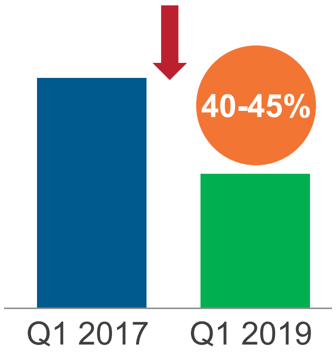
PER RECENT LIVE DEAL EXPERIENCE

Fact: IT Infrastructure unit pricing for certain resource units has decreased by up to 20-45% over the past two years. Are you still in the legacy era?

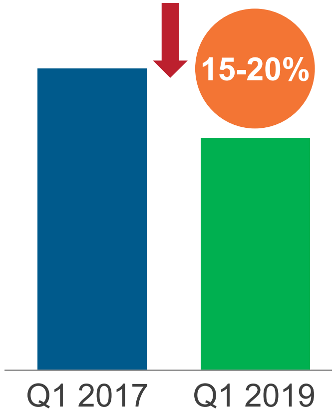
Price per VM



Price per TB of storage



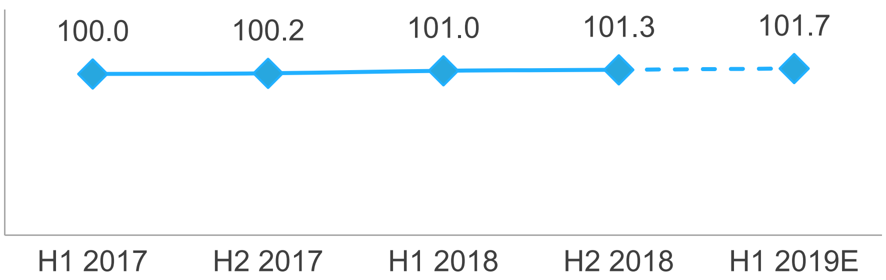
Price per Integrated log source (SIEM)



Additional context		
• 500-2000 VM environment • Offshore price • Year 1 price in the deal • Remote management support	• 2-5 PB environment • SAN Tier 1 storage • Offshore price • Year 1 price in the deal • Remote management support	• 2500-3000 EPS environment • Offshore price • Year 1 price in the deal • Full managed service as a price (includes cost of SIEM tool)

FTE rates for IT Applications could increase in onshore locations, but we expect them to be flat in offshore locations primarily driven by FX depreciation and competition/commoditization

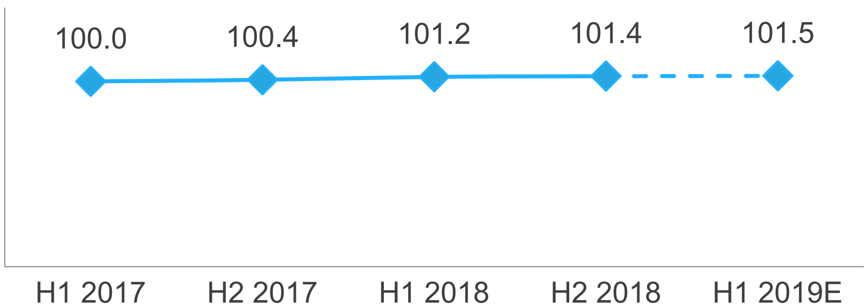
Trend in blended FTE price in onshore[1] geographies
H1 2017 indexed to 100



Key demand-side and supply-side drivers

- Rates have increased consistently (though marginally) due to fair market conditions and slight inflation
- An increasing number of large “run” deals combined with digital transformation components, resulting in large engagements
- Upward movement expected in rates due to sustained demand and potential talent gap due to visa issues (especially for USA)

Trend in blended FTE price in offshore[2] geographies
H1 2017 indexed to 100



Key demand-side and supply-side drivers

- Rates have remained almost stable due to competition and currency depreciation against the U.S. dollar
- Traditional IT services pricing will continue to face pressure due to automation and commoditization
- Digital-focused skill sets are expected to hold their pricing due to sustained demand

1 Representative of the US, UK, Canada, and Australia
2 Representative of India and Philippines

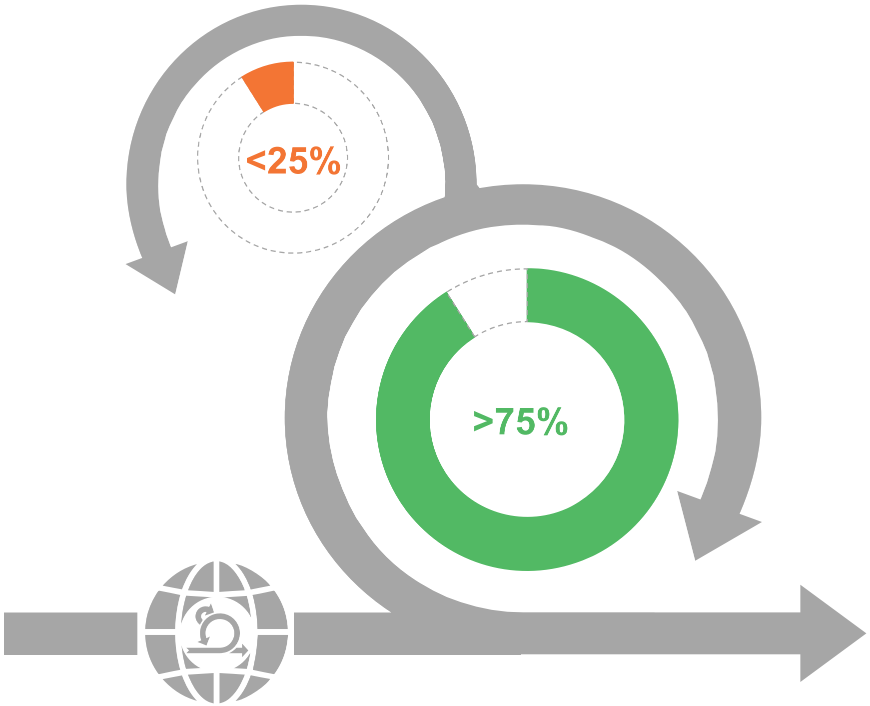
Discussion points for today

- Pricing models are changing, but not as one block
- Expected near-term pricing movement
- **Evolution of contracting tenets**
- Q&A

Quick Poll #2
How frequently do you think a basic tenet such as Cost of Living Adjustment (COLA) comes up for negotiation?

- **<21% of situations**
- **21-40% of situations**
- **41-60% of situations**
- **>60% of situations**

COLA[1] as a theme has come up in over 75% of the contract related discussions we have cup up in the past 12 months



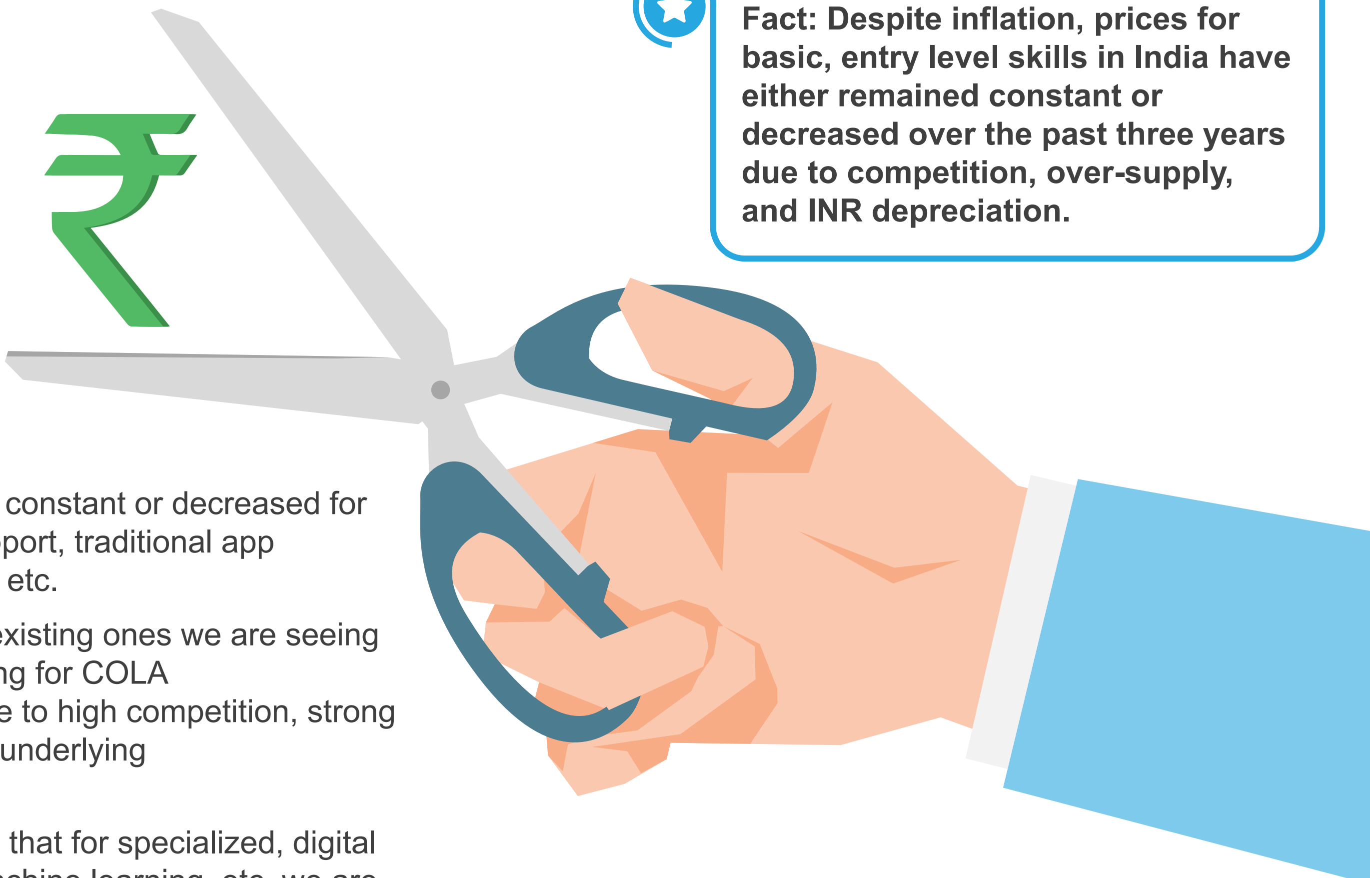
Common themes

- Are we paying too much?
- What is the correct index?
- How do we ensure it is fair for both parties?
- The most prevalent calculation model?

Between April 2018 and April 2019, COLA has **been a key topic in over 75%** of the contract benchmarking and renewal discussions we have been involved in

1 Cost of Living Adjustment

Why should we care about pricing?



Fact: Despite inflation, prices for basic, entry level skills in India have either remained constant or decreased over the past three years due to competition, over-supply, and INR depreciation.

- Entry level skills have remained constant or decreased for commoditized work such as support, traditional app development, functional testing, etc.
- Not just in new deals, even for existing ones we are seeing pushback from enterprises asking for COLA to be absorbed. Much of it is due to high competition, strong talent supply, and of course the underlying FX rate changes
- However, it is important to know that for specialized, digital focused skills such as cloud, Machine learning, etc. we are seeing increased rates even at entry level

COLA could potentially have a cascading adverse effect on total charges over the contract tenure if structured improperly

What is COLA?

- Over the tenure of a contract, the service provider could incur changes in delivery cost
- The COLA clause provides service providers with the ability to adjust charges to reflect a fair increase in delivery costs
- This adjustment is typically performed annually at the anniversary of the contract or Statement of Work (SoW)

Key principles of calculation

- A standard mechanism for adjusting charges should include:
  - The milestone(s)
  - The index
  - Sensitivity
  - Formula
- The index used should be easily accessible and reflect the correct inflation applicable
- A historical view of index values should be reviewed before contract signature

COLA has a cascading effect and could be **a hidden choke point** within a contract. Choice of an equitable index, sensitivity, and formula are critical to ensuring that service provider charges remain aligned with the market.

The service management regime is also getting stringent, as seen by the higher fee-at-risk being demanded by most enterprise clients

Typical range of fee-at-risk in outsourcing deals
% of monthly fee

TYPICAL RANGES

2016-17		2018-19
11-14%	>>>	14-16%

Typical cumulative pool %
Sum of severity weight across all critical SLAs

2016-17		2018-19
150-200%	>>>	180-240%

As deals become complex, there is a higher expectation of **"skin in the game"** from service providers. One of the ways in which it is manifested is stronger penalties for poor performance on critical metrics

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Key implications for enterprises

1. IT Infrastructure services pricing is witnessing material changes – it is advisable to get external validation on bids to minimize over-paying or under-solutioning
2. FTE rates for basic IT services are expected to be flat for offshore locations, however they could increase marginally in the US and other onshore locations
3. Do not ignore the *seemingly* standard Cost of Living Adjustment clause in your contract – it could be causing significant value leakage
4. For newer, Digital focused (typically Agile) deals a sequential evolution from T&M to other models is seen as a common phenomenon
5. Higher deal complexity requires stronger service management guardrails to ensure right service provider behavior – ensure the fee at risk is aligned and equitable

Overview of Pricing Assurance Services

Everest Group's Pricing Assurance practice serves Enterprises, Service providers, and Service enablers on a range of pricing and commercial topics

Service enablers (Country organizations, Investment advisory, Professional services)
- Confirmatory due diligence
- Contract Terms & Conditions assessment
- Services pricing validation and insights on potential pricing movement

Enterprises
- Strategic Engagement Reviews (SER)
- Sole-sourced Proposal Reviews (SPR)
- PriceBook
- Price benchmark catalog access
- Custom price and performance benchmark intelligence

Service providers
- Price benchmark catalog access
- Custom price to win support
- Insights on contemporary solution and commercial themes
- Live bid and pursuit support
- Win rate assessments

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Special Offer – Labor Rates

WHAT Complimentary price checks on up to three standard roles in up to three different countries

HOW To participate, contact either Michel or Abhishek (email addresses on following slide), or send us a quick note now via the Chat panel

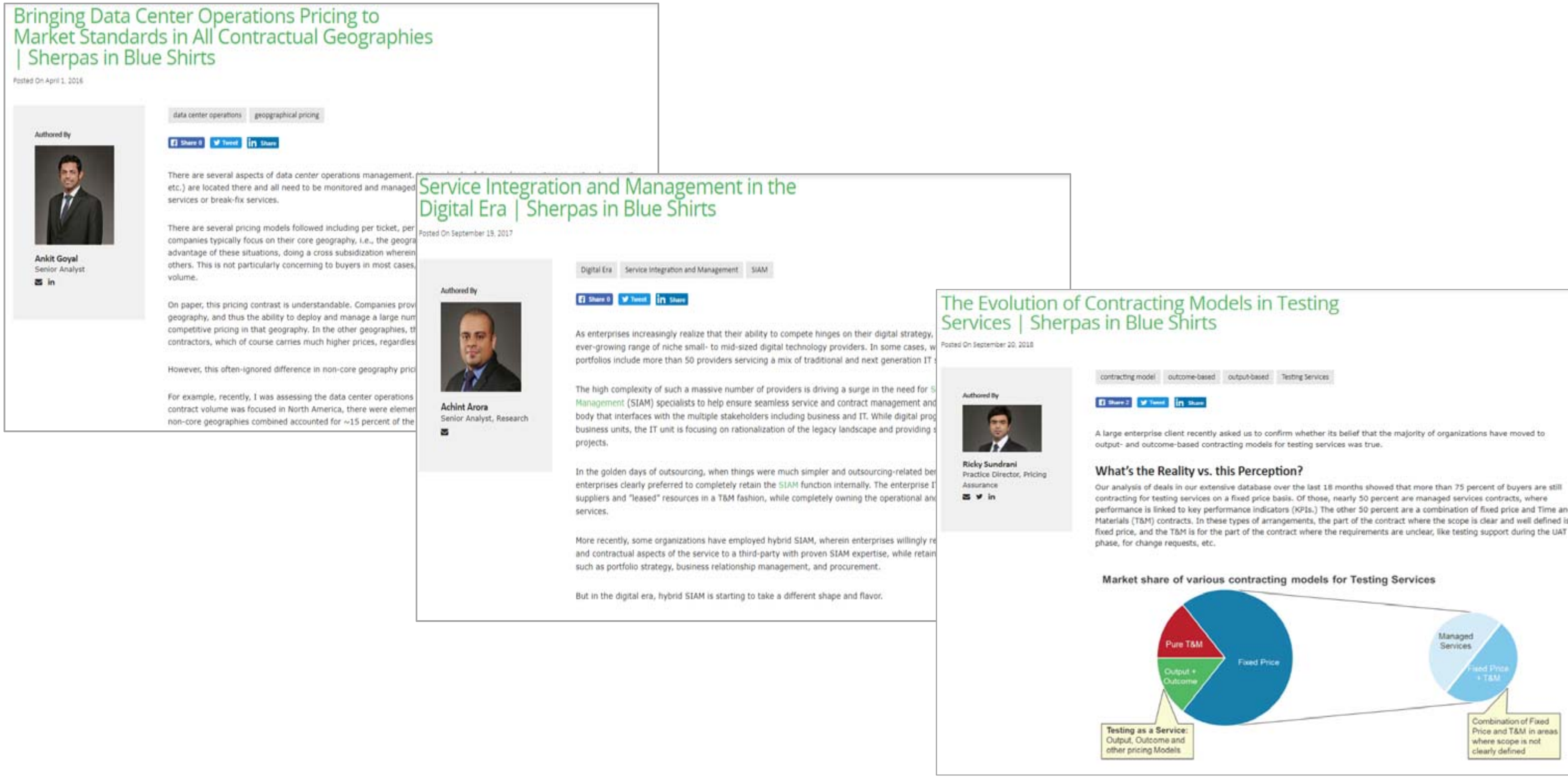
Have a question?

To ask a question during the live Q&A session

- Access the **Questions** panel within the GoToWebinar console, which is typically located on the right side of your screen
- Type your question in the dialogue box, then select **Send Privately** to submit the question to our session organizers/panelists

- Attendees will receive an email with instructions to access the slides and playback of today's presentation
- For general questions, or to learn more about how Everest Group can assist your organization, contact us any time at everestgrp.com
- For scheduling a diagnostic assessment of your contract, or consultation on contract alignment, please contact:
  - Michel Janssen michel.janssen@everestgrp.com
  - Abhishek Sharma abhishek.sharma@everestgrp.com

Check out our blog for the latest perspectives on pricing and contracting for global services



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