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TBR SPECIAL REPORT

Service delivery model evolution, metrics and survival tips

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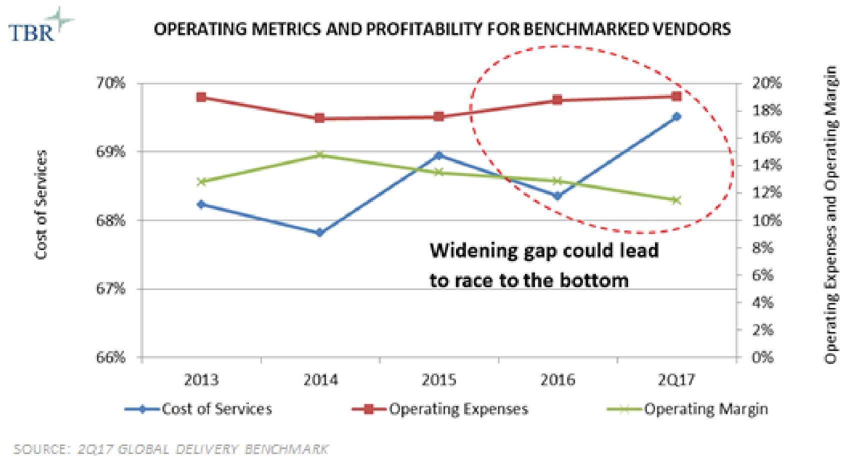
TBR perspective

Digital transformation, automation, artificial intelligence (AI), cognitive, robotics, cyber, cloud and other buzzwords are swirling across stakeholders within enterprises and IT services providers. The effort to keep up with using, integrating or just talking about the coolest and most innovative gadgets and applications has forced many providers to sideline the true purpose of their businesses. We don't think automation or any of the other aforementioned trends will likely abate anytime soon, but we believe vendors that look in the mirror first before heading out the door and try to sell stuff, outcomes, value, etc., are the ones that can survive in the long run. Processes and technology are great, but company culture trumps them both as the one prerequisite that leadership must ensure is aligned with market demand and the broader stakeholder community.

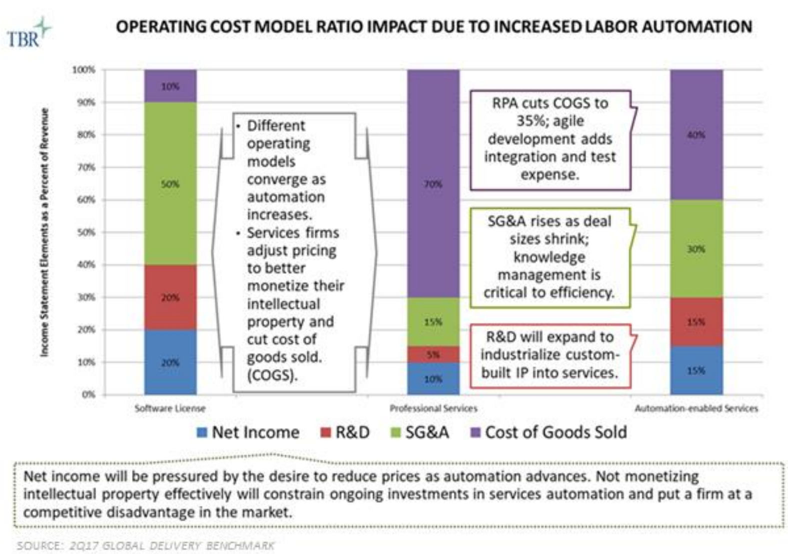
Zooming in on customer zero

Enterprise demand for cost savings has been, and continues to be, the key driver behind the IT services market evolution. From the dawn of outsourcing to robosourcing today, IT services vendors have constantly been striving to address that demand, applying levers such as labor arbitrage, consolidating software engines, and now utilizing adaptive and prescriptive tools — all in the name of making clients happy, winning RFPs and let's just say it: improving shareholder value. However, the speed and scale of competition is forcing vendors to juggle even more complex tasks, expanding capabilities in unchartered territories (e.g., creative services) while ensuring they have the right size and smart-skilled workforce bench. TBR sees this chaos in the IT services cosmos compelling vendors to take a historical look at other industries that have gone through similar transformation changes.

In the dawn of the internet, the newspaper industry saw the new technology as a channel to promote content. All was great until declining newspaper sales and market consolidation forced some publications to go out of business while others asked readers to pay for subscriptions. The IT services market is at a similar crossroads, where vendors invest in automation tools to improve, standardize and speed up service delivery to pass cost savings to clients to remain competitive. One may argue that IBM (NYSE: IBM) is The New York Times (NYSE: NYT) and Amazon Web Services is BuzzFeed. As a result, vendors' bottom lines are pressured especially as they struggle to ramp up "digitally" infused awards. We do not think progress will stall, but we believe vendors' approach to embrace being digital first and doing digital second enhances their value proposition. Additionally, not monetizing intellectual property effectively will constrain ongoing investments in services automation and put firms at a competitive disadvantage in the market.



While it is easier said than done, we believe vendors that start transforming their cultures and adopt KPIs that resonate with both software and services companies have a better chance of executing on their promises around digital transformation without facing a race-to-the-bottom scenario. Putting products into services requires vendors to restructure their operating cost structures. For example, while robotic process automation (RPA) cuts cost of services, agile development adds integration and test expense. SG&A rises as deal sizes shrink, making knowledge management critical to efficiency. Lastly, R&D spend expands to industrialize custom-built IP into services.



Transition not transformation

Marketing messaging creates a hype that vendors and buyers must live by. Filtering through the noise and appealing to the right buyers requires suppliers know which offerings to market and how to position their offerings without overselling and underdelivering. For example, the CIO always wants to know what cost-saving KPIs look like, regardless if vendors use labor arbitrage or automation tools. The CFO, however, sees applying automation in service delivery as becoming the guiding principle for establishing the enterprise of the future, where all tasks and processes are executed at a 100% compliance rate without human intervention. Adjusting to these requirements is not an easy task for IT services vendors that historically have been using low-cost leverage and utilization as core metrics to productivity and tying them to the impact on profitability.

New benchmarking metrics around the use of automation can help suppliers and buyers compete better and capture the most value on their investments, including:

- Innovation spend
- Percentage of FTEs automated
- Employee development and certifications
- Total RPA cost
- Speed: start versus stop time of a process before and after automation deployment
- Productivity: length of time a human spends on a task compared to a robot
- Quality: output accuracy before and after automation tools deployment
- Compliance: compliance percentage before and after automation tools deployment

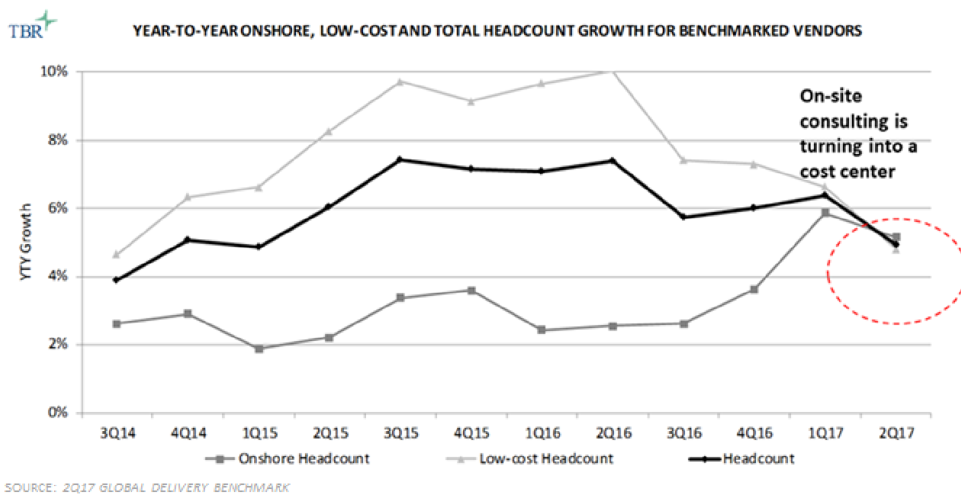
TBR sees these metrics as some of the fundamentals that can help IT services vendors ease their transition toward adopting automation-enabled cost structure and fine-tune their go-to-market messaging addressing key buyers' core beliefs. The degree of success around each of these KPIs will depend on multiple factors, including automation market maturity level; vendors' automation tools development strategies; vendors' packaging, bundling and service delivery strategies as well as vendors' ability to reskill, upskill and certify resources in new areas.

Patents will likely emerge as a differentiator, at least initially, as vendors try to fill gaps in portfolio offerings to address industry pain points. As the market matures, establishing certifications in automation-enabled service delivery similar to Capability Maturity Model Integration (CMMI) levels has enabled outsourcing organizations to showcase their commitment to buyers' performance, quality and profitability across IT and business process services, filtering the noise around transformation and providing visibility for the "What's next?" question in the professional services market. Standards around technology development and connectivity will become must-haves as today not every connection in the services technology ecosystem creates value and a use case for each client.

From scale to skills

Just like the use of automation results in the need for new technologies to be integrated with existing systems, grooming the right skilled bench will remain a key challenge and an opportunity for IT services vendors, which for many years have relied on an army of people to develop, deploy and manage what today can be seen as low-level tasks. Educating and developing technical experts who can create differentiating business applications and processes in the era of AI will guide suppliers in their resource management strategies. We do not believe automation will black out the outsourcing industry, but rather partially eclipse it, creating new partnerships between humans and machines, demanding society readiness and fine-tuning the public-private trust.

Opening and managing delivery centers across the globe have been part of the outsourcing equation over the past two decades. Staffing them with entry-level college graduates to industry laterals helped IT services vendors create a sector on their own where scale in nearshore and low-cost hubs was a key pivot in a pricing war. As a result, countries such as India and the Philippines turned from frontier to emerging markets. With the advent of subscription-based models and automation in service delivery, vendors are forced to recalibrate the composition of their workforce across legacy and new service lines. The demand for mobile-based applications and creative commerce services, among other services and solutions, has compelled vendors to expand their capabilities in the search for new buyers. Launching innovation centers and/or design studios with a vertical and/or industry focus has become the latest trend that most IT services providers and consultancies have jumped on. Client selection, locations, partners and staffing models are among the differences in center operations from vendor to vendor. The common denominator, however, remains the human component of client interaction. Measuring successful strategy execution and return on real estate and resource investments has yet to gain visibility. But, as with every hype that draws tangible investments, the industry needs to put a stake in the ground and begin to standardize metrics to make it easier to track performance.



What some vendors do

At TBR, analysis starts at the company level, understanding what each vendor excels at, how it sets strategy, which investments it makes, and how all those elements reveal themselves in the vendor's financial performance. The big picture painted above began with portraits of individual vendors. A few examples:

Accenture

Grooming a scalable workforce with skills in high-growth and emerging areas while embedding operational intelligence solutions in service delivery such as myWizard and Accenture Touchless Testing Platform enables Accenture (NYSE: ACN) to address demand efficiently. Accenture continues to target recruits who boast skills in areas such as analytics and cybersecurity as well as certifications in deploying cloud and software solutions. As Accenture expands its relationships with partners, such as SAP (NYSE: SAP), Oracle (NYSE: ORCL) and Microsoft (Nasdaq: MSFT), among others, and adopts agile-based delivery methodologies, the company's investments in training programs as well as the opening of Liquid Studios across regions will help it keep pace with demand. Acquisitions remain a critical part of Accenture's ability to build talent, IP and reach, evidenced by the company's 37 purchases during FY17.

Atos

Placing technology and scientific talent close to clients will enable Atos to support its growth through 2019 and position as clients' digital transformation partner. Atos is building digital competencies, including through hiring digital talent, retaining experts and training 50,000 employees on digital. The company's HR vision emphasizes building a Tier 1 employee organization and improving the employee experience by creating a great place to work. To refresh its skill set with digitally versed people, the company is aiming for graduate recruitment to compose 15% of total hiring by 2020. Applying HR analytics in candidate profiling and predicting enables Atos to make informed decisions when identifying the right candidates, while digitized and automated HR services improve the speed of hiring. Developing talent, creating career paths, applying an "experts policy" for approximately 5,000 people and certifying 20,000 people on digital enable Atos to enhance its digital skills internally.

IBM

Infusing Watson into IT services offerings reduces delivery costs and improves services value but also requires continued skill remixing. IBM will offset the hiring of more expensive industry and consulting professionals by training nontraditional workers in digital skills. To add employees with "new collar" skills, the company announced plans to partner with more than a dozen community colleges in cities near IBM's existing facilities to provide internship and employment opportunities for students outside traditional four-year degree programs. Many of these partnerships involve IBM developing curricula and lending employees to provide training around skills that are key to IBM's strategic imperatives, primarily cloud, security, data science and AI. At the same time, offshore locations such as India, Romania and China will continue to provide support in IBM's legacy lines of business, such as mobile application development and security operations management, that require scale.

Impact and opportunities

Low-cost hubs will remain critical to vendors' global delivery models, especially in areas such as application services that require scale. However, development and adoption of analytics-enhanced service delivery and project management platforms signal vendors' delivery future lies in cognitive-enabled automation, not labor arbitrage. As labor costs continue to rise in historically low-cost regions and digital solutions increasingly require onshore expertise and support, automation will become table stakes for IT services vendors to sustain margins. The integration of automation solutions positions vendors to not only offset investments in onshore digital talent and client centers but also monetize their own IP through value-added service offerings. Reaching critical mass of monetizing IP will be key for long-term sustainability.

TBR will continue to monitor the evolution of service delivery models and begin to track vendors' performance across the aforementioned metrics to account for investments in automation and the impact on vendors' value proposition. We understand the implications on operations that new automation tools and platforms create. But as value to price remains a critical attribute for vendor selection across most of the processes within the enterprise ecosystem, capturing variables beyond low-cost leverage that impact vendors' pricing and profitability levels will provide winning suppliers insights necessary to strengthen their positions.

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