

Confidence in the face of turmoil

Making sourcing decisions in an
economic downturn*



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Overview

Difficult economic conditions around the world have encouraged many executives to look at alternative service delivery models like outsourcing and offshoring as a means of addressing various short- and long-term business concerns.

We believe that these models provide significant opportunities, but recommend taking additional care to assess and understand the complexities of an increasingly volatile market. Only then can executives make effective decisions that will stand the test of time.

The sourcing decision

Effective business strategies are typically created with both long- and short-term views in mind. They are expected to bridge the gap between reality and vision, prudence and opportunity. The true test of these strategies – and the tactics employed to inform and implement them – is whether they stand up in times of dramatic and unanticipated change.

The financial crisis that began in the debt markets has now escalated into a global malaise affecting developed and developing countries alike. Stock markets around the world are in constant, unpredictable flux, causing a significant erosion of shareholder value. Volatility in the currency markets has exacerbated the situation and, from a macro-economic standpoint, growth in many industrialized countries is already in decline.

Confronted – and often confused – by a plethora of unprecedented challenges, organizations typically “freeze” in an effort to minimize their risks until more stable times. They focus on immediate operational and tactical issues, and defer mid- to long-term growth or improvement initiatives. While executives clearly realize the importance strategy plays in the long run – in reducing costs, improving quality, gaining flexibility, securing talent and remaining competitive – few can resist the internal pressure to retrench.

Over the past few weeks, we have seen many organizations:

- Put a temporary hold on most of their discretionary spending initiatives;
- Review all their operational areas to identify any opportunities for cutting costs; and
- Start cutting their workforce.

Though prioritizing and reducing expenditure on IT, finance, human resources and other back-office functions is prudent during economic downturns, it is also important to realize that cutting jobs in such areas is not a sustainable approach, unless the underlying work activity is also redesigned or eliminated. Failure to make the necessary changes will lead to disruption and productivity losses, as well as leaving companies at a competitive disadvantage in the longer term.

Over the past five years, many of our clients around the world have embraced offshoring and outsourcing as a valuable means of reducing their costs and streamlining their back-office operations. The mechanisms that support the globalization of service delivery have also matured, accelerating this process. As confidence has risen, organizations have routinely tapped into service and supply capabilities around the world – using a mixture of insourcing and outsourcing arrangements in both onshore and offshore locations – to secure cost savings, efficiencies and other such benefits.

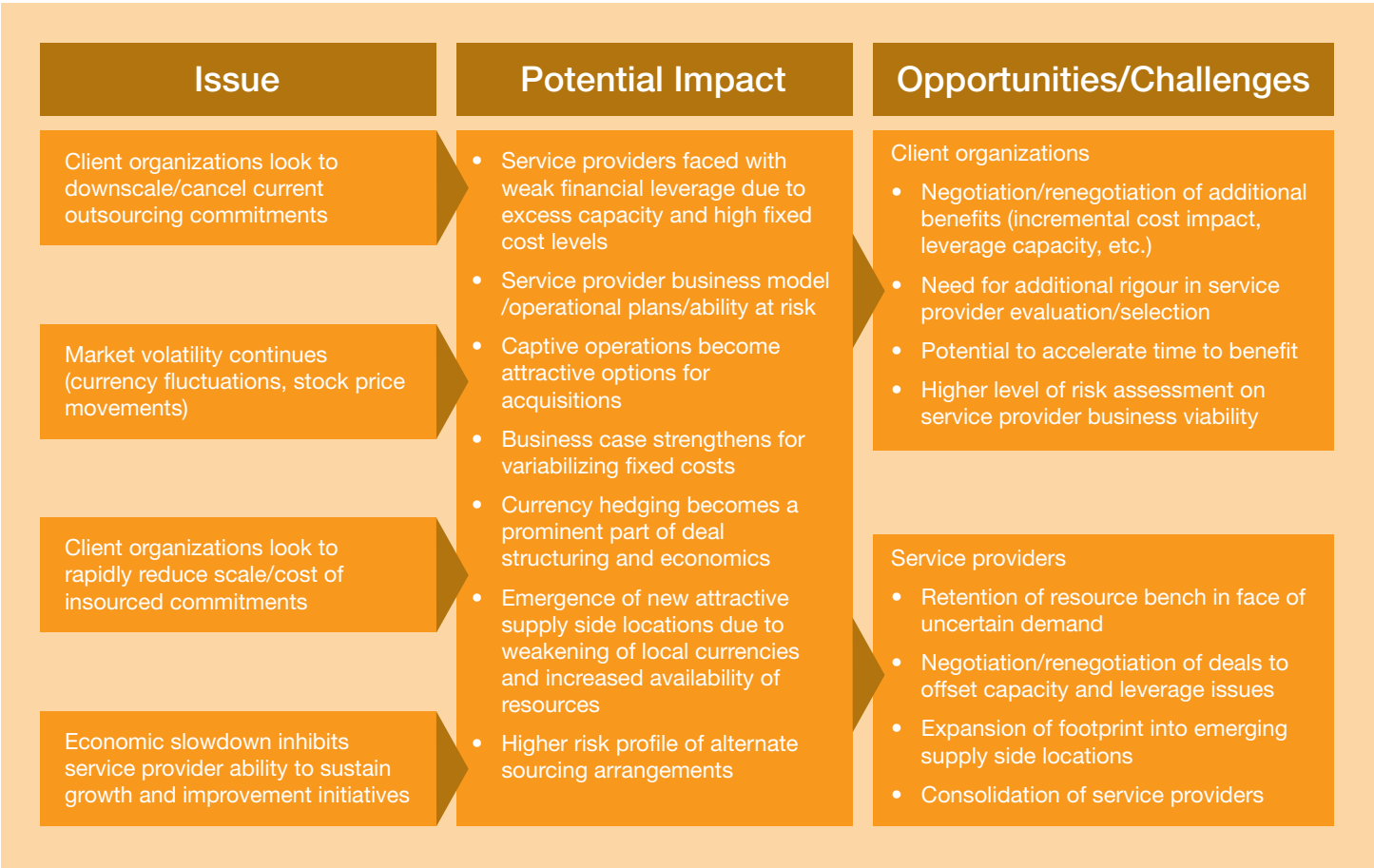
But now times are tough, and the current economic and market conditions have had both a direct and indirect impact on these sourcing practices. Many organizations appear to be in a state of paralysis in terms of effective decision making.

We anticipate that although it appears organizations are ‘on pause’, the pressure to take action will drive many to do so in haste and with little assessment of impacts of the additional complexity and opportunities created by the current market conditions on their longer term business strategy. For organizations already seeing the benefits from outsourcing/offshoring and for those looking to enter into such arrangements, the dilemma is clear: both the opportunities to extract value and the risks involved in alternate service delivery models have increased.

In our view, standing on the sidelines is NOT an efficient response in these uncertain times and urge organizations to adopt a structured approach to evaluate and implement suitable alternate service delivery strategies.

Situation analysis

So what should such organizations do? Figure 1 highlights the key areas they should consider and identifies the potential implications for companies on both sides of the alternative service delivery arrangement.



Even in the best of times outsourcing solutions require careful planning and structuring to deliver full value. The temptation now is to move quickly to extract additional value. But, in the face of growing economic uncertainty and increasing market complexity, outsourcing arrangements demand a higher level of scrutiny and focus. Acknowledging the need for caution and due diligence, there are nevertheless specific actions that organizations can take to review, refresh and reshape their sourcing strategies, contracts and relationships to reflect new economic and market realities.



Impact of the economic downturn on those making new outsourcing arrangements

Organizations looking to enter into new outsourcing arrangements should consider the following imperatives in the new market environment:

| Key Decision Factor | Imperatives in the new economic realities |
|-------------------------------|---|
| Scale and scope determination | Determine and/or validate the scale and scope of work appropriate for an outsourcing arrangement, with additional emphasis on options to accelerate the rollout or expand the scope to maximize any new value extraction opportunities. |
| Service provider evaluation | <p>Ensure evaluation of potential service providers includes a thorough assessment of the impact of the current crisis on current and future operations to understand the risk perspective as well as additional value extraction opportunities. Focus on service providers' ability to service debt liabilities and fund required investments as well as any potential impact of commitments made to and/or by other clients within their portfolio.</p> <p>Consider currency hedging as an important aspect of your business case assessment. See Exhibit 1 – Impact of Foreign Exchange Volatility.</p> <p>Enhance focus on risk assessment and mitigation early in the evaluation process. A more detailed due diligence process may be required with potential partners and service providers.</p> |
| Structure of the arrangement | <p>Consider new locations (nearshore/offshore) that may now offer an attractive proposition to structure the delivery model.</p> <p>As service providers are moving towards periods of slower growth, encourage profit sharing and performance based incentive arrangements.</p> <p>Consider cost of financing leverage (access to capital at more attractive terms than service provider) to structure cost effective payment terms.</p> |

Exhibit 1: The Impact of Foreign Exchange Volatility

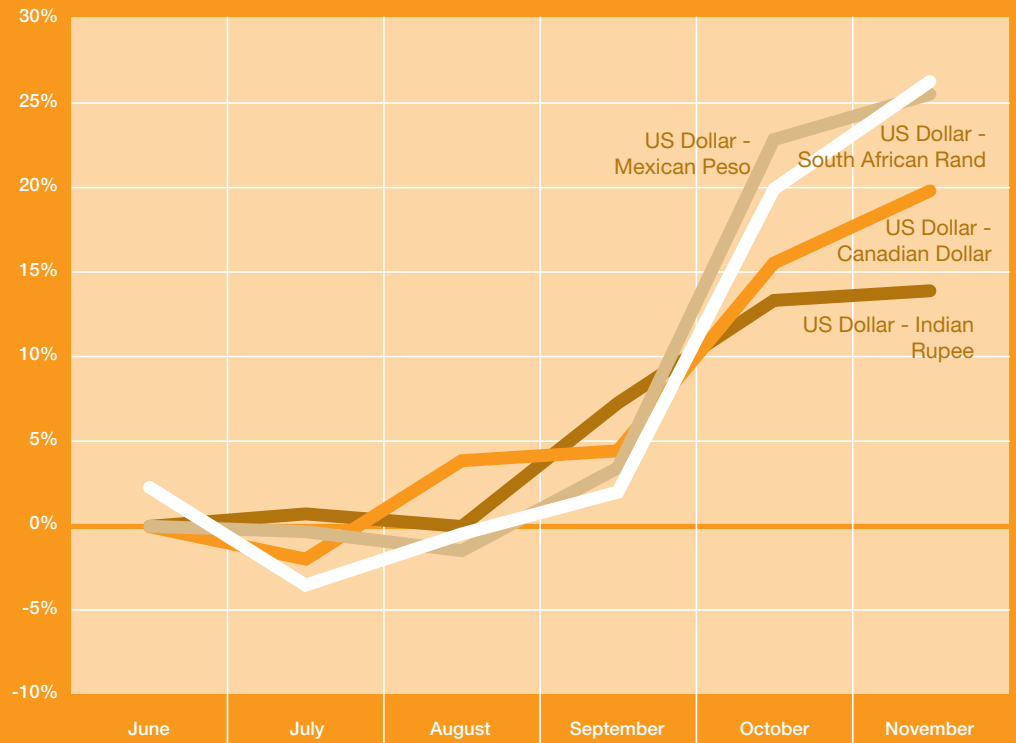
Consider the role currency hedging now plays in your business case assessment.

Sourcing arrangements involving cross-border transactions often increase an organization's exchange rate exposure. Most organizations respond in one of four ways:

- They enter into a contract in their home currency, leaving the risk to the service provider
- They assume that their hedging exposure is countered by other areas within their business
- They put short-term hedging arrangements in place
- They use contract terms to address special situations.

However, in the current economic environment, exchange rates are fluctuating so dramatically that it is essential to monitor the situation very carefully. Since June 2008, currencies of many locations have weakened against the US dollar (as shown in the table below) increasing their attractiveness as destinations for outsourcing/offshoring.

To illustrate how currency volatility could impact the economics of an outsourcing arrangement, consider the scenario where an organization is evaluating the option of transacting either in the local currency or in US\$.



A contract denominated in the local currency of the buyer organization (CAD, GBP) would have resulted in no additional exposure from an outlay to the buyer organization, whereas the service provider would have taken an economic hit (CAD – INR and GBP-INR movements respectively) — unless of course the contract was properly hedged. However, if the contract were denominated in US dollars, the clients would have taken the economic hit, while the service provider would have gained when translating the receipts into its local currency.

Contracts with clauses that allow for periodic adjustments in response to currency fluctuation during the contract term minimize the impact to both sides. The absence of such clauses results in disproportionate and often unintended financial treatments, and can lead to tension in the sourcing relationship. Companies should seek expert advice on foreign exchange exposure to ensure options have been considered (such as using derivative contracts and performing simulations of foreign exchange fluctuations) in the terms of the agreement with the service provider to allow for a fair treatment of gains and losses for both client and provider.

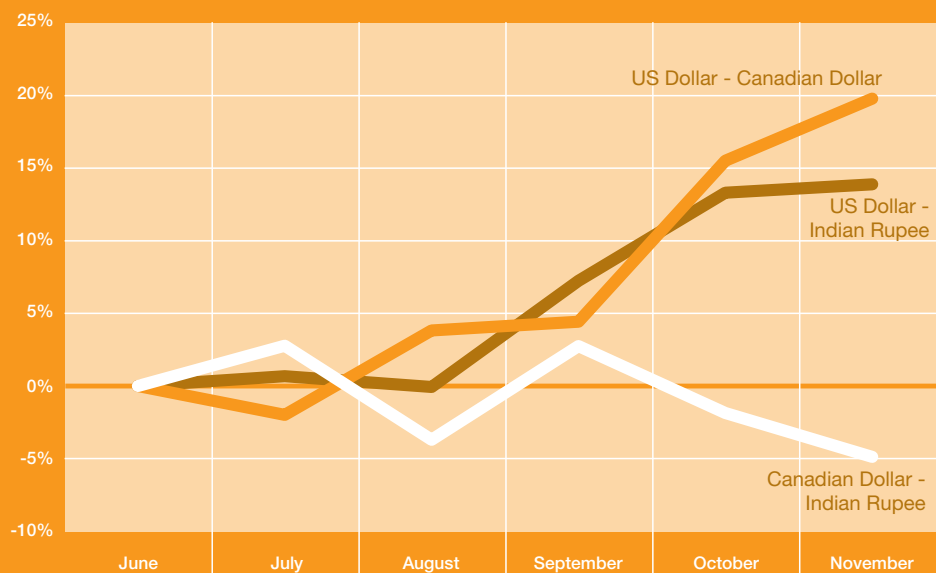


Illustration 1: organization in Canada, service provider in India

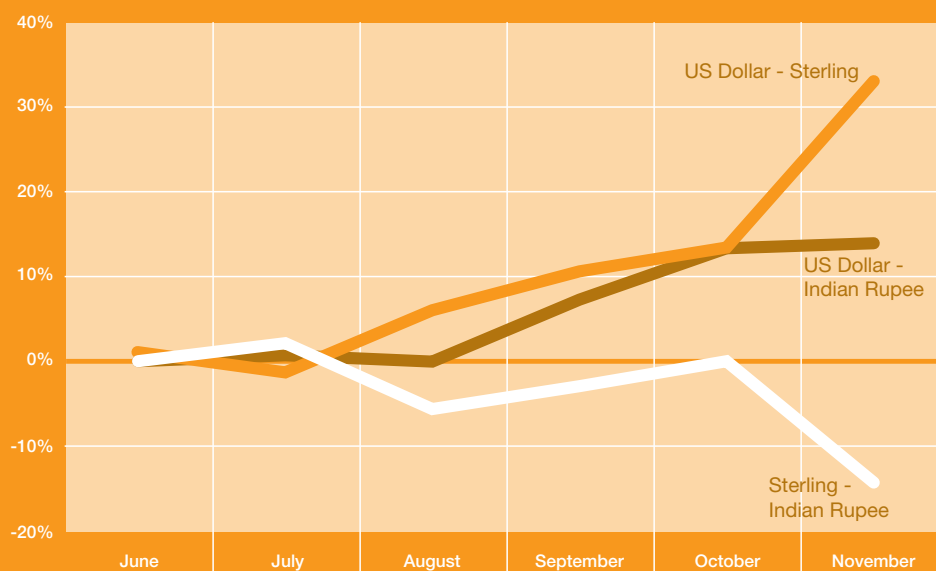


Illustration 2: organization in the UK, service provider in India

Impact of the economic downturn on those renewing outsourcing arrangements

Organizations with existing outsourcing arrangements (i.e. those with outsourcing and insourcing/captive centre models) should consider the following imperatives in the new market environment:

| Key Decision Factor | Imperatives in the new economic realities |
|----------------------------|---|
| Business continuity | <p>Assess and understand the viability of your service provider as a going concern.</p> <p>Review service provider expectations and commitments in existing arrangements and identify areas that need additional focus. Direct special attention to obligations requiring additional investments over the next 12-18 months and consider alternatives where appropriate.</p> |
| Scope change | <p>Assess whether the objectives of the original business model and business case are still being met and that they have been adjusted to account for any change to your business strategy/requirements.</p> <p>Consider the need to change the scope, scale, terms and focus of the current arrangement to reduce or increase commitment level.</p> <p>Assess current and future impact of the downturn on service providers and determine their ability to continue to provide service and value. Evaluate additional service providers to either augment or replace current service providers. Consider rationalizing the number of service provider under contract. Remember that any evaluation of service providers and the arrangement should allow for additional complexity factors.</p> |
| Termination/re-negotiation | <p>Assess the likelihood that service provider arrangements will support evolving business needs in response to the downturn. Review and understand your contractual obligations and rights. You may not be able to exit without penalties, but in unprecedented times, both parties may be happy to re-negotiate to release and reallocate precious resources.</p> <p>Consider opportunity to adjust location strategy in light of new opportunities.</p> <p>Engage immediately with your service provider to find way to minimize the adverse impact of termination.</p> |

Conclusion

PricewaterhouseCoopers believes that the current market conditions have provided new opportunities for organizations that are already outsourcing, or planning to outsource, their back-office functions to reap significant financial and non-financial benefits from their arrangements. Many organizations would do well to explore these opportunities. Greater market complexity and risk are concerns that certainly require serious consideration, but they should not stop organizations from taking a step that could enhance their flexibility and competitive strength when the economy recovers.

How PricewaterhouseCoopers can help

Increasingly, value is created across a complex network of partners, suppliers, customers, regulators and stakeholders, and success depends on collaboration amongst them. When it comes to outsourcing, the challenge for organizations lies in finding the time and skilled resources needed to manage complex and often risky global arrangements. Is your business equipped with the insight, skills and resources to ensure success?

PricewaterhouseCoopers' Consulting team can help execute your business strategy with advice and implementation – locally and globally. As trusted advisors across the entire sourcing arrangement, we bring rigour and discipline to decision making, and drive value by fixing distressed deals, reducing risk in complex contracts, and forming the partnership bridge between buyers and providers. We help our clients to formulate and implement strategies, reduce costs, increase efficiency, drive innovation and expand into new markets.

We take the time to listen and have the courage to debate different points of view – based on independent and challenging insights, supported by facts and industry benchmarks. We give you the confidence to succeed in a connected world.

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