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Why Do You Need Tier Two Providers? (And You Do Need Them!)

Understanding The Specialization Value Tier Two Providers Can Offer

This is the first document in the "Working With Tier Two Offshore Providers" series.

by Sudin Apte
with Andrew Parker and Philipp Karcher

EXECUTIVE SUMMARY

Many clients today are looking to add one or two midsize IT service providers to their current portfolios of top offshore companies. But the offshore midmarket is full of confusion — it includes a crowd of 300-plus players, and almost 90% of them look the same. To cherry-pick specialists from dozens of undifferentiated service providers, sourcing teams need to revisit their approach and reasons to select small partners. To ensure your midsize service providers deliver incremental value over and above your large suppliers, you need to understand the character and type of their specialization, as well as the situations in which they are most useful.

CLIENTS CHOOSE MIDSIZE FIRMS TO GET LOW RATES AND CONTROL

Whether to work with tier one offshore providers like Infosys and Tata Consultancy Services or with some of the hundreds of tier two firms is a long-running debate. Top Indian providers boast of their reliability and their financial strength based on criteria like revenue, growth rates, profitability, scale, and ability to invest back in the business. On the other hand, tier two providers — typically below the billion-dollar revenue threshold — claim that they offer better service and attention to their clients. Such "personal" attention becomes harder for tier one providers to offer as they grow in size to more than 120,000 people. But why do clients choose (or ignore) midsize providers? Our interactions with several clients who are making this decision — be it vendor rationalization, selecting providers for specific skills or capabilities, or adding a tier two provider to the current mix — indicate that they have a very different perspective from the services firms. They think tier two providers:

- **Offer lower rates.** Most clients believe that top Indian providers like Wipro and Cognizant are costly and less flexible in rate negotiations. Conversely, small and midsize players are keen for business and drop prices to win new business. A large majority of clients — those who mostly use the time-and-materials (T&M) pricing model — told Forrester that their tier two suppliers offer anywhere from 10% to 20% lower rates than their tier one partners.

- **Are flexible and easy to work with.** A sourcing professional with a financial services company justified his recent shift to a midsize provider by his claim that tier two providers are more nimble in situations like accepting change orders, committing company-specific payment and other contract terms, and agreeing to stringent service-level agreements (SLAs). This claim was echoed by another sourcing exec at a major European insurance firm that is currently adding a tier two provider to accommodate changing business demands and fluctuations in workload. He finds that his current tier one supplier is not agile, demanding compensation for every variation. He was also irritated that the incumbent provider linked the billing rate to work volume.

- **Still maintain the traditional offshore working style.** A common peeve we heard was that tier one firms are becoming more like Accenture and IBM. Several execs complained that the Indian biggies are no longer interested in small deals, are very pushy about work volume ramp-up time, want to bypass operating management and reach C-level execs, have lost that personal touch as they've grown to more than 100,000 in headcount, and even show flashes of arrogance. On the other hand, these clients found that tier two providers are hungry for business and are still prepared to work the way top players served their clients five years or a decade ago.

- **Offer niche capability.** Just a few sourcing people mentioned to Forrester that they select a given supplier for its specific skills or capabilities. In such cases, the provider's focus on a technology or specific offering ensures they have enough trained resources and are updated in that domain.

POPULAR REASONS TO WORK WITH TIER TWO PROVIDERS ARE FLAWED

In most client situations, reasons for selecting a tier two provider boil down to low cost and a flexible approach to working with clients. In the cold light of day, the lower cost that clients perceive is available from tier two firms is essentially linked to billing rate cards. And perceived provider flexibility reflects the smaller firms' inability to push back on unreasonable expectations. But these seemingly powerful advantages often leave clients dissatisfied with providers after two to three years. Why? Forrester observes three common pitfalls that prevent such an oversimplistic vendor selection from delivering long-term value.

- **Lower rates don't necessarily mean lower overall cost.** In the final analysis, billing rate is only one piece in the makeup of project cost. The provider's productivity, technology excellence, team configuration, and ability to handle complex work contribute more than mere rates. Furthermore, software engineering factors like per person throughput (e.g., lines of code in a day), "first time right" code (i.e., number of bugs in a volume of code), tools, automatic code generators, and quality processes also dramatically impact total cost per function point in software development. Considering these multiple and complex considerations, the lowest hourly billing rates don't always result in lowest cost of delivery.

- **A fine line exists between vendor flexibility and chaotic (or no) strategy.** In several negotiations where Forrester had access, we saw that small providers often end up accepting work outside of their comfort zone to defend the current revenue in an account. Then they start building capability, resources, and often effectively pilot the first project at client cost. Examples of this might include application-work-focused companies accepting infrastructure

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management contracts or starting a testing practice at a client's behest. This may sound like client-centricity, and the buyers involved may think that they are able to push the work to their existing provider — saving the effort needed to find and educate an alternative. But in the long run these midtier players find themselves operating all over the technology map and end up with too many service lines for their size.[1]

- **Innovation doesn't come cheap and easy.** Billing rates are relatively easy to evaluate, and considering only rates may be good enough for low-skill and fairly commoditized types of work. In many other types of work, however, you need to evaluate much more complex factors such as future value of the relationship and service innovation. Our recent interviews with some tier one providers like Infosys and Cognizant show that these companies have spent several tens of millions of dollars in creating a broad range of capabilities and intellectual property (IP) that focus on areas such as project productivity, deep-down micro-vertical capability, centers of excellence around client pains, business process IP and platforms, and efforts to harness emerging technologies.

  Why are providers making these investments? They want to develop future-oriented capabilities and value to give their clients the next generation of benefits. The providers that win deals on low cost are unable to invest in such innovative solutions, compromising future client value. Buying complex projects or similar specialist work on mere rate comparisons may prove uneconomic in the long run.

TIER TWO PROVIDERS CAN DELIVER MORE VALUE THROUGH SPECIALIZATION

Many offshore services buyers look at rates as their primary selection criterion, while smaller providers often compromise their strategy to accept unsuitable work to show client "flexibility." This sets up the clients involved for longer-term challenges as providers fall short of underlying service requirements. Does that mean that buyers should completely avoid tier two and small providers? And do all tier two providers have problems with investing? Not at all. There are several midsize providers that clearly differentiate themselves based on a unique value proposition.[2] They offer an incremental value-add, a unique specialization — via client focus, specific deep-dive capability, or specific technology or unique IP — that large companies will not normally be in a position to match.

Understand Three Types Of Offshore Vendor Specialization

Identifying relevant and long-lasting provider specialization can be tough. Furthermore, segmenting and evaluating providers becomes even more difficult if an apples to apples comparison isn't possible. To help solve this puzzle and to reveal the pro and cons of various categories, Forrester divides the vendor value propositions into the following three categories:

1. **Specialization around line of service or technology.** Providers in this category build their value proposition and differentiation based on a specific type of work or technology. Examples

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in this category include AppLabs (independent testing services), Microland (infrastructure management), and Virtusa (application platform) that focus on specific lines of service. Firms like Torry Harris focus on service-oriented architecture (SOA) technologies, whereas ThoughtWorks focuses on Agile delivery methodology. These firms, in order to deliver incremental value, build specialist domain capability by hiring experts, develop proprietary tools and methodologies to improve efficiency, and create reusable software components to assist rapid solution deployment.

2. **Specialization around industry verticals and business processes.** The players in this category build industry-specific knowledge and solutions. They focus their centers of excellence on harnessing business processes and domain capability. Many players in this category also do senior-level recruitment from the industry to emphasize their commitment and to help them to tailor solutions that match buyer requirements. Tech Mahindra (telecom), Polaris, Nucleus Software, and Syntel (banking and financial services), Kale Consultants (airlines), and KPIT Cummins (auto) all represent this category.

3. **Specialization that offers a unique client experience across the outsourcing life cycle.** This specialization, possibly a new category for most clients, is difficult to demonstrate and evaluate. Firms in this category — for example Collabera, Syntel, and UST Global — focus on the soft capabilities of their staff that make them easy to deal with and offer a responsive experience through all stages of the business relationship. They offer flexible engagement models, a client-friendly style of dealing, transparent pricing, top management involvement, and they go the extra mile to delight clients. They do say "no" to their clients' unrealistic expectations and firmly stay within their selected offering spectrum. They invest in recruiting senior staff for sales and presales solutioning (often from tier one providers) and relationship building and high standard client service is their second name. Furthermore, this category of specialization offers multiple benefits. For example, vertical specialist firm Syntel, by emphasizing strong client-centricity, further reinforces its value to its clients beyond the simple relevance of its solutions.

RECOMMENDATIONS

HOW TO SELECT THE RIGHT SPECIALIZATION FOR YOUR WORK

Depending on the needs and objectives of the relationship in terms of value and duration, sourcing professionals need to evaluate midsize specialists. The value each provider can bring to your business varies dramatically, and you need an effective selection process to match provider profiles to the benefits and inputs required. Here is Forrester's advice on how to view these three categories of providers:

- **Service line/technology specialists.** Sourcing teams need to examine the sustained value available from these types of specialists most carefully. Technology-led specialization tends to need refreshing frequently, or the provider involved will simply lose its edge relative to

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its competitors. And some areas of technology focus will prove less valuable than expected, over time. What's more, providers often fall into the trap of building scale beyond the original core focus, broadening out their offering to support higher revenues but diluting the very value that they headlined at first. For example, Hexaware wants to position itself as an enterprise application company today, rather than continuing its more focused HR IT or PeopleSoft specialization. Pick technology and service-line specialists in this category for specific projects that are very clearly defined and that have an engagement life of two to three years. These providers are also suitable for either new technology pilots or for maintaining niche applications.

- **Industry vertical specialists.** This specialization is relatively difficult to build compared with technology capability — recruiting domain experts and creating business-side solutions is much tougher than digesting new technology and building scale. Of course, providers also need knowledge of the underlying technology stack and the ability to deliver and integrate that part of work. The best invest heavily in their client-facing roles to stand up to multinational and top offshore competitors. Buyers should consider such leading providers for work involving higher domain capability and in projects that actively involve the business leadership. They are also a good complementary fit when employed alongside large offshore generalists like Tata Consultancy Services or Wipro that focus on technology and productivity.
- **Customer experience specialists.** Consider Cognizant 10 years ago. It typifies — and arguably was the first offshore pure play to leverage — this specialization. Its subsequent success clearly demonstrates the merit of this specialization and its long-term value delivery. But it's extremely difficult to build organizational DNA that truly lives this approach, and buyers risk being deceived by phony customer experience specialists who may showcase similar culture short term. Sourcing professionals should select these specialists as their trusted lieutenants to bridge the gaps that your top providers can't fill. Keeping one or two such specialists among your preferred suppliers will also keep a constant pressure on your other service providers. Good words about their service and their ever-growing fan base in an account always encourage the other providers to raise their game.

ENDNOTES

[1] Client-driven growth has landed most midsize and small players in a mire of nonspecialization. They run large numbers of service lines and support too many verticals for their size and client base. See the August 5, 2008, "Surviving The Offshore Vendor Polarization Puzzle" report.

[2] There are still many smaller reputable providers that can deliver the cost and quality benefits as well the flexibility and customer service benefits that buyers have come to expect. Sourcing and vendor management teams that are willing to invest extra time evaluating these midsize firms will find players that specialize in certain vertical or horizontal areas in order to differentiate and to better compete. See the April 14, 2008, "Not The Usual Suspects Part II: Cost, Quality, And Client Service Benefits From Midtier Providers" report.

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