Impact of Recession on the Business Process Services (BPS) Industry

A Primer for Service Providers to Manage and Thrive | March 2020

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Introduction

Since the last recession, the global economy has been on an expansion spree. But are the good times coming to an end? At the time of publication of this report, there is enough evidence to say that the economy seems to have cooled off. Factors such as geopolitical uncertainty, the COVID-19 outbreak, and economic instability in many countries suggest that we maybe on the path to recession. It is only a matter of time before we know whether it is a slowdown or a recession. Consequently, multiple countries are on a recession watch – alarmed by these recent events.

During a recession, many sectors will be impacted – global services being one of them. Enterprises will be looking for short-term cost reductions, such as prudent use of cash, working capital, and capex. As a result, decisions around outsourcing functions that do not offer rapid gains may be delayed and more attention paid to engagements that can provide quick benefits. During the recession of 2008-09, many IT-BPS providers were affected and were forced to revise their growth forecasts and reexamine their hiring and expansion plans as a result of the global downturn.

Having said that, there will be opportunities for well-prepared service providers to emerge as winners during and after a recession. For them, what matters is not the timing or duration of the downturn, but rather what they can do to navigate it and how to propel themselves to the top once they are out of it. While cost reduction seems to be the obvious move, it is only the tip of the iceberg. Service providers should seize this opportunity and leverage it to develop strategies that will provide them with short- and long-term gains, something that will benefit them coming out of the downturn.

This report outlines our take on the likely impact of a recession on the BPS industry. Because this industry is quite heterogenous, having a more nuanced view of the market across BPS segments (e.g., HR vs. F&A) is critical. The report describes a framework for service providers to identify the relative impact of the recession on the various BPS segments. The paper also discusses the strategies for service providers to navigate a potential recession.

Scope of the paper

Drawing insights from our extensive research as well as interactions with market stakeholders, this study addresses the following topics:

- Likely impact of a recession on the BPS industry
  - Comparison of the likely impact with the recession of 2008-09
- Steps service providers need to take to navigate a recession
  - Analysis and evaluation of BPS segments to understand the likely impact on each
  - Understanding of the impact on the service providers' overall BPS portfolios
  - Understanding of service providers' financial positions and appropriate steps

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Speculations of a recession

The year 2019 was something of a roller-coaster for those who closely track recession forecasts. There were many sources across the world that suggested a downturn was imminent, while others disagreed. Institutions such as the World Bank and Goldman Sachs said that recession in 2020 was unlikely due to healthy fundamental drivers of growth in major economies such as the US, Europe, and China despite manufacturing sector troubles and the China-US trade war. However, after the turn of the year, the situation has changed. The ongoing COVID-19 scare and its impact on the global businesses seem to indicate that the world economy may already be on a path to recession. Consequently, there has been much speculation about the global financial markets crash, recession, and the impact it would have on the world.

Indicators of recession

Yield curve inversion: The 10-2 Year Treasury yield spread in the US is a closely followed recession indicator. The inversion of the yield curve is a typical phenomenon before every recession. In 2019, it inverted for the first time since the recession of 2008-09 (see Exhibit 1). The fact that the yield curve has bounced back into positive territory does not help, as it has happened before and still recessions have hit soon after.

Purchasing Managers' Index: Another leading indicator of a downturn is the Purchasing Managers' Index (PMI). PMI is an index of the prevailing direction of economic trends in the manufacturing and service sectors, and any value below 50 indicates shrinkage in the overall manufacturing activity. The Eurozone PMI index has been below 50 for the past 13 months (see Exhibit 2). If this trend continues, it will become a serious concern as the other sectors may not be able to offset this contraction.

COVID-19: Isolations and disruptions to contain the spread of the virus will have a mounting economic impact. On one hand, as people limit travel and vacations, the travel and hospitality industries are impacted and have a bleak outlook. The film industry is also hit as movie theaters across the affected areas are being closed and major releases delayed. On the other hand, industries such as semi-conductors, electronics, manufacturing, and medical devices are being affected as their suppliers are dependent on the most affected areas including China, Italy, and South Korea, and are unable to deliver products and materials.

Many companies are already facing the effects of these, which leads many to believe that we maybe moving toward a recession. As a result, business leaders across the globe are concerned and are thinking of possible next steps.

During the recession of 2008, many companies went out of business through lack of preparation. Although we cannot predict the severity of the next downturn, it is important for leaders to be well-prepared. While coping with the downturn will be the priority, it is also prudent to look ahead and think of strategies to emerge stronger afterward.

EXHIBIT 1

10-year treasury constant maturity minus two-year treasury constant maturity

Source: Everest Group (2020) and Federal Reserve Bank of St. Louis

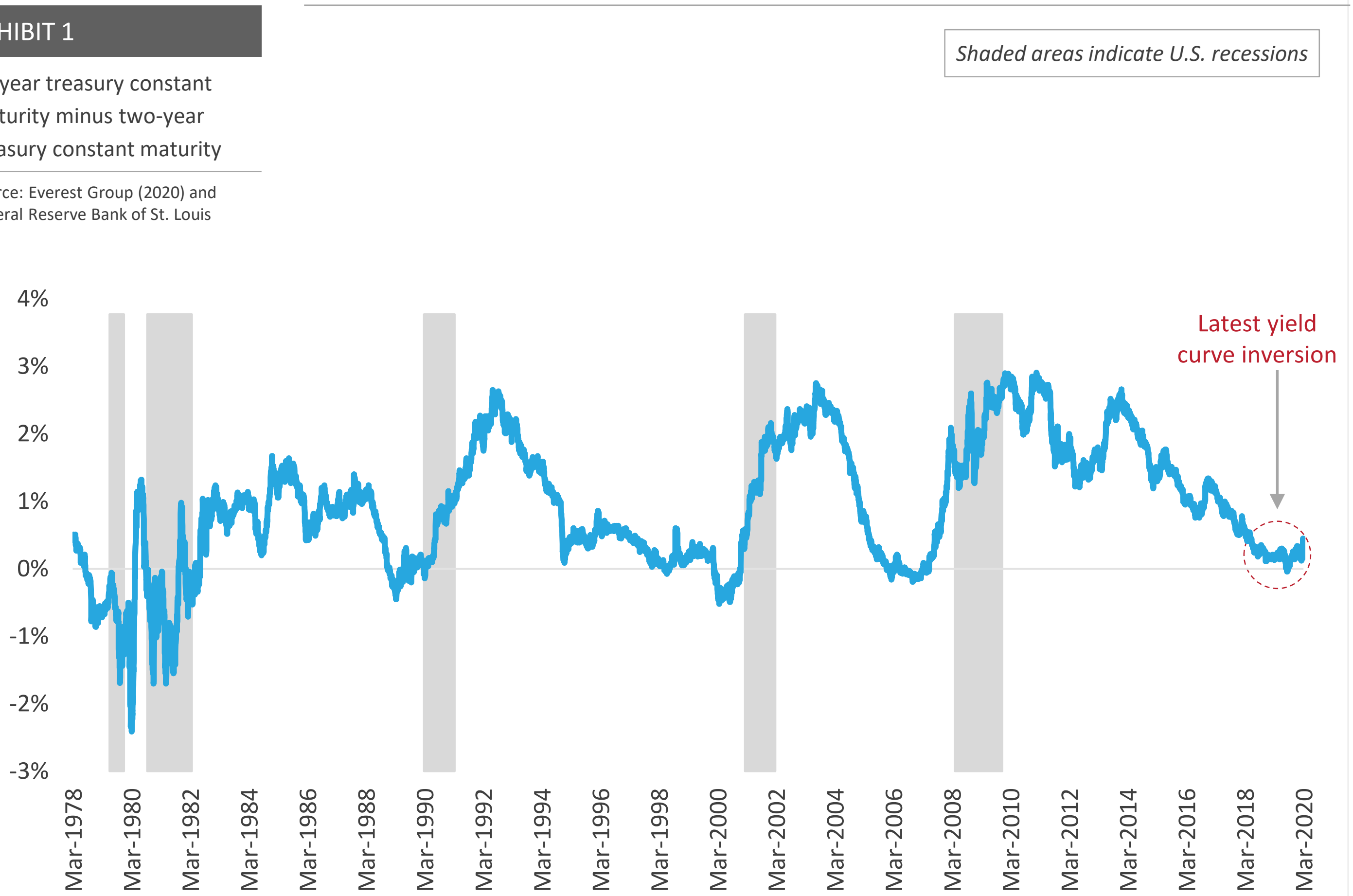
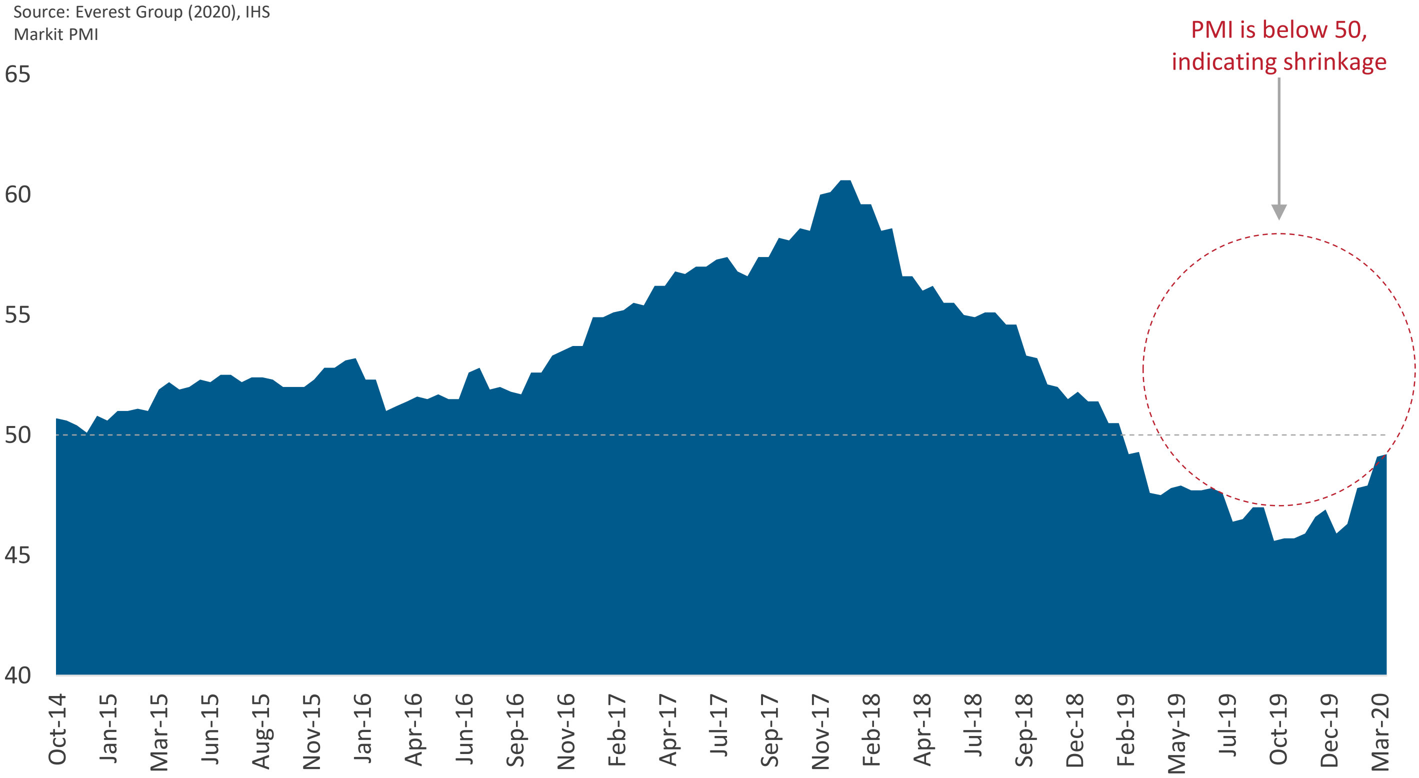


EXHIBIT 2

Eurozone manufacturing PMI

Source: Everest Group (2020), IHS Markit PMI



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Impact of a downturn on the BPS industry

During a downturn, many non-time-critical decisions – which otherwise would have been relevant, such as outsourcing decisions – may be de-prioritized. A global slowdown may also force enterprises to put on hold new or large investments, expansions, or even sourcing decisions. Hence, we can expect the BPS industry to be impacted during a downturn.

Top effects of a downturn on the BPS industry

Enterprises will look for quick and tangible benefits: Because the goal of enterprises will be to ensure short-term cost wins, they will be looking for quick and tangible benefits from all their investments. BPS engagements/constructs that can provide immediate cost benefits to enterprises will fare better than those that provide delayed benefits.

Contract renewals and negotiations will be tougher: On one hand, enterprises will try to squeeze in more value into the contract for a lower price, especially enterprises from industries that are heavily impacted by the downturn. On the other hand, enterprises may look for a no-frills approach to outsourcing – removing non-essential components from deals – resulting in a decline in the Total Contract Value (TCV).

As the economic cycle enters a downturn, the competition will become fiercer, as there will now be many providers fighting over a smaller pie. Also, a downturn will result in decline in prices and some of the weaker providers closing shop.

Talent will be impacted: A global slowdown may force service providers to reduce hiring, freeze salaries, or reduce their workforces. India's National Association of Software and Service Companies (NASSCOM) estimated that the country's IT-BPS sector created 50,000 fewer jobs in 2008 than 2007. Moreover, retention of good talent will continue to remain a challenge and, in some cases, may become more difficult if not managed well.

Chance to emerge stronger: During hard times, service providers will be impacted negatively for inefficiencies that they shrugged off in better times. It also means general cost-cutting and introspection for service providers, from which they can emerge stronger with improved capabilities and market standing. At the end of the downturn, outsourcing will boom, and service providers that take the right steps will be successful.

Comparing the impact on the BPS and ITS industries

The ITS industry was more impacted than the BPS industry during the recession of 2008-09. While the BPS industry showed a dip in growth, its overall market size did not decline, while the ITS market did decline in 2009. One reason for this is the fact that enterprises typically have discretionary spends for IT services or project-based work, which typically takes a back seat during a recession. In contrast, BPO engagements typically have longer contracts and are relatively less exposed to risk.

Moreover, as expected, both sectors witnessed a significant uptick right after the recession. However, the ITS industry had significant growth in the years after the recession, compared to the BPS market due to the decline in 2008. If there is a recession in the near future, we can expect the same.

As Exhibit 3 shows, BPS is growing faster than ITS at this time. If past trends hold, the gap between BPS and ITS will further increase during a recession.

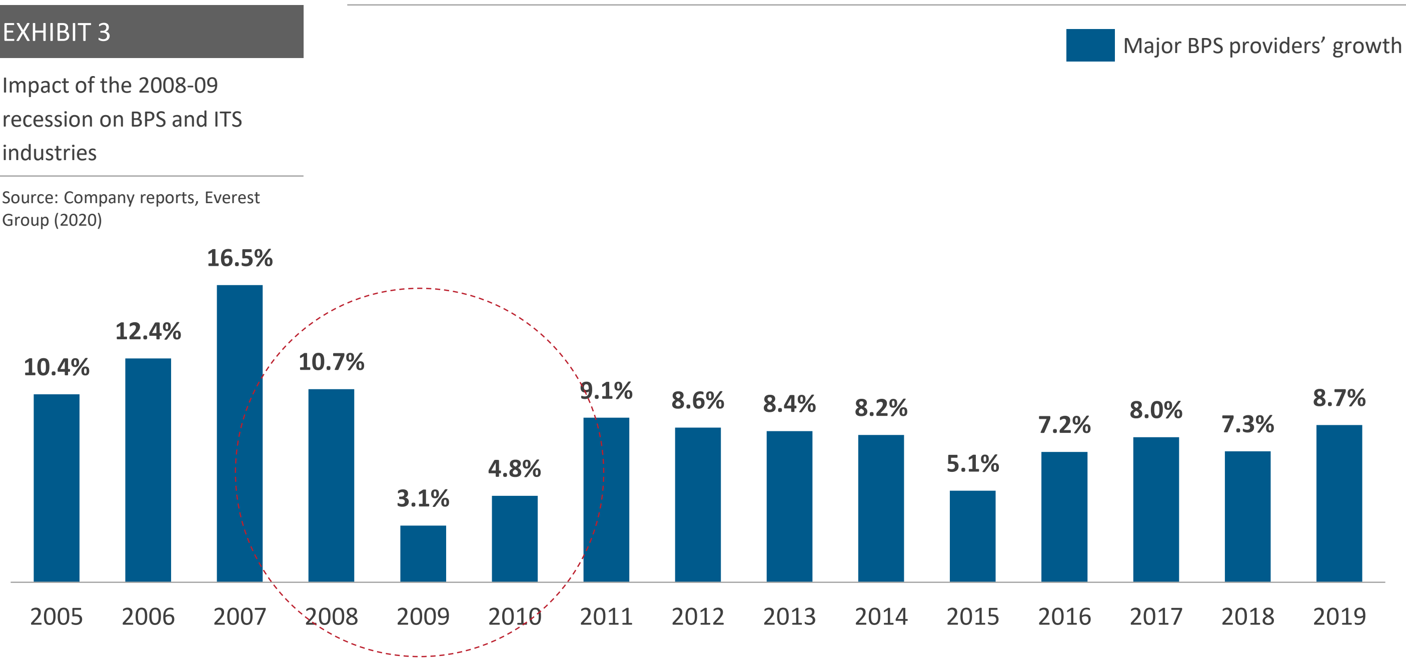
The BPS industry will be better than in the 2008 recession

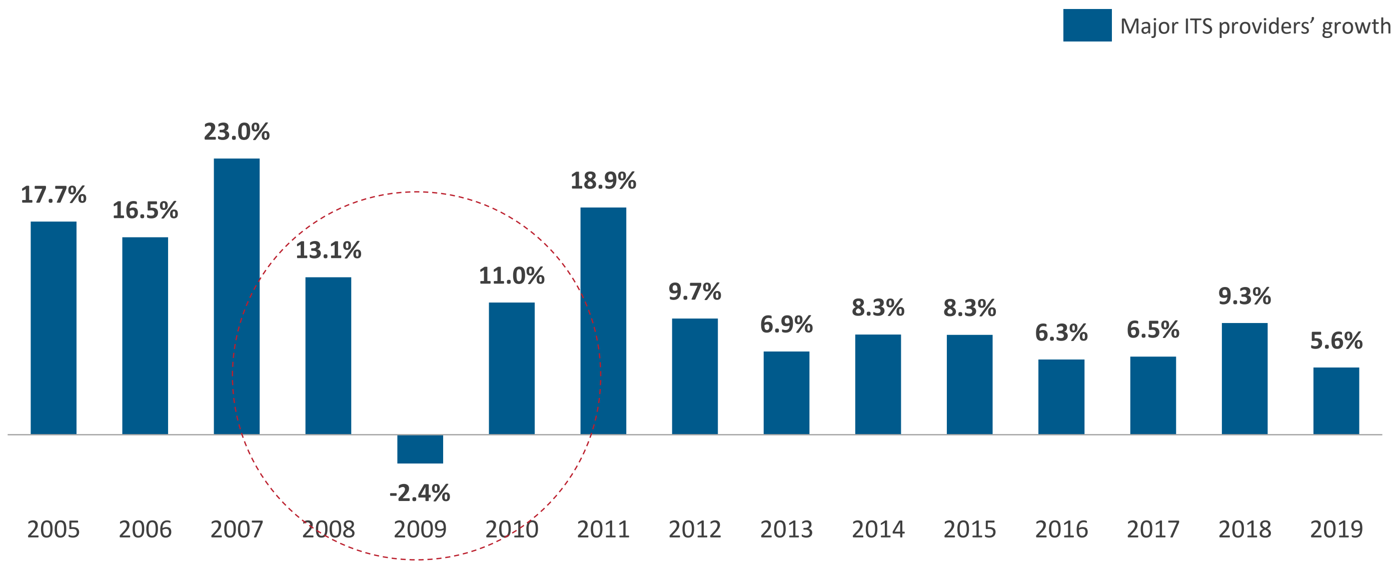
While in the past, the main focus of BPS was cost reduction, it has evolved over the years to be more expansive, adding value such as providing top-line impact. In addition, it was the early days for the BPS segment 2008-09, and there were structural issues with many segments, which caused a more pronounced impact. Moreover, the past recession of 2008-09 was severe; many believe that if a recession occurs now, it will be less harsh. Also, the BPS industry is fundamentally stronger than in the last recession; that, in conjunction with its evolved role, makes it appear likely to be less affected now.

EXHIBIT 3

Impact of the 2008-09 recession on BPS and ITS industries

Source: Company reports, Everest Group (2020)





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How can service providers navigate a recession?

Recessions are famous for breaking companies. But what few people realize is that recessions are equally likely to strengthen a company's reputation. We also know that for corporate leaders, the timing of the next downturn is probably less important than the answer to a couple of simple questions – What will be the impact on business? How can we be prepared to take the right steps to navigate the downturn?

Preparing as early as possible enables companies to be in a better position than competitors, which will help them manage the downturn and accelerate the recovery. The recession of 2008 shuffled the deck for many industries – with companies that were well-prepared making it to the top at the end of the downturn and the others failing. It is vital to have the right strategies to come out of the downturn strongly.

Service providers should consider three key steps to handle the recession and emerge stronger afterward; (see Exhibit 4):

1. Analyze and evaluate BPS segments to understand the likely impact on each
2. Understand the impact on your overall BPS portfolio
3. Understand your financial position and take appropriate steps

EXHIBIT 4

Approach to identify the recession's impact and take appropriate steps to succeed during recession

Source: Everest Group (2020)

Analyze and evaluate individual BPS segments	**Understand the impact on your overall BPS portfolio**	**Understand service provider's financial position and take appropriate steps**
Activity: Assess each BPS segment using the four parameters described in Exhibits 5 and 6 to identify impact on each BPS segment	Activity: Position the different BPS segments on the impact assessment matrix using each segment's market standing and output from step 1	Activity: Assess your current financial position and use Exhibits 9 and 10 to map out the right steps for each segment
Output: Relative sensitivity of the BPS segments to the recession	Output: Identification the most and least impacted segments in the event of recession	Output: Identification of the right strategies to thrive during a recession

Step 1: Analyze and evaluate BPS segments to understand the likely impact on each

Impact on BPS segments: During a recession, it is important for service providers to understand impact on each operational segment in order to take appropriate measures.

Keep in mind that during a recession prices and volumes are impacted. To understand the impact on each segment, it is necessary to identify the impact on existing BPS deals, new deal activity, and prices. The four parameters noted in Exhibits 5 and 6 help you to identify the impact on different BPS segments from different perspectives.

Combining the results from all the parameters, you arrive at the overall impact on the different BPS segments. Exhibit 7 examines and contrasts two BPS markets to illustrate this framework.

EXHIBIT 5

Parameters used to assess the impact on BPS segments

Source: Everest Group (2020)

Parameter	Description
Volume sensitivity	• Many enterprise functions are core to a business and need to be carried out in the same way regardless of macroeconomic conditions. At the same time, many are sensitive to a recession and will experience volume declines • For example, healthcare payer BPO will be less sensitive to a recession as the processes within it, such as processing claims data, will need to be done during a recession. In contrast, the recruitment function is highly sensitive and will be negatively impacted
Cost optimization timeframe	• With certain outsourcing engagements, it is possible for enterprises to realize cost-optimization quickly – a key objective for many during a recession. Though primarily applicable to segments where the lift-and-shift model is prevalent, it also occurs in segments with innovative constructs • In contrast, some engagements may take a longer to realize cost benefits due to the transformative nature of the engagement or lack of arbitrage opportunities in the segment. For such segments, the impact of recession will be higher
Market penetration	• Segments that are mature and have a relatively higher penetration of the Total Addressable Market (TAM) will have less room for growth in general, but this limit may be even more pronounced during a recession • In contrast, segments that are relatively under-penetrated – the demand clearly exists, but the market is yet to catch up – will be better off, given the greater headroom for growth
Nature of the process	• For a process that is commoditized, the impact of a recession on prices and, therefore, the segment, will be higher, because the competition will drive down prices to win more deals • In contrast, BPS segments that are differentiated will be less impacted, as there will not be a large impact on the pricing

EXHIBIT 6

Framework to assess the impact on a BPS segment

Source: Everest Group (2020)

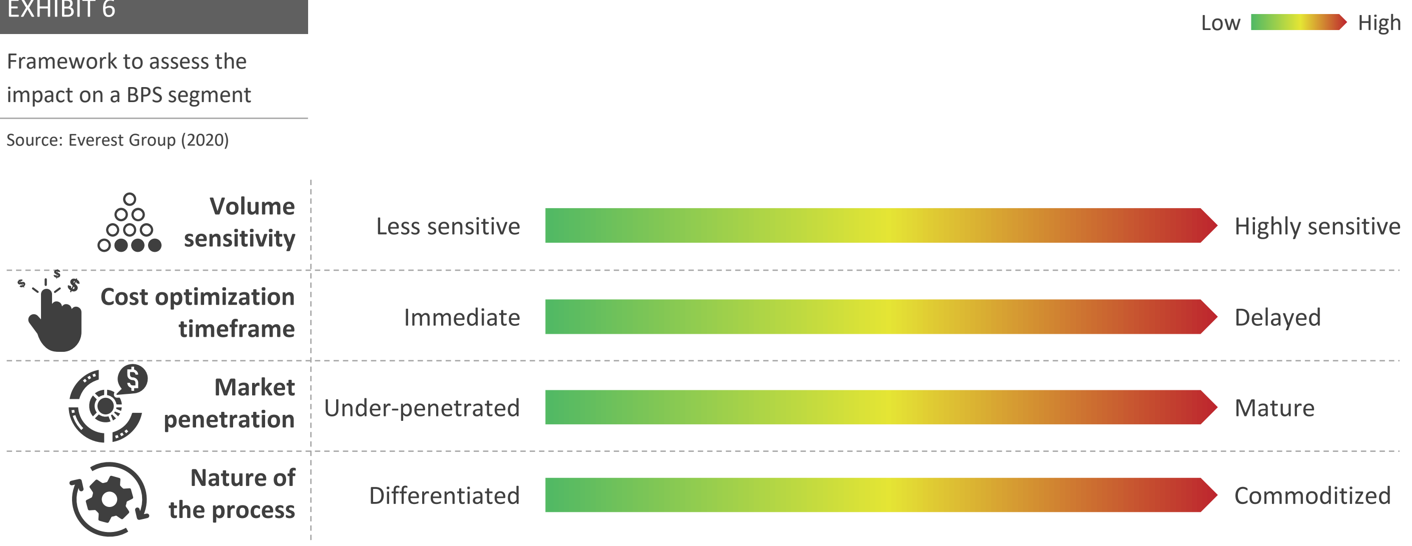
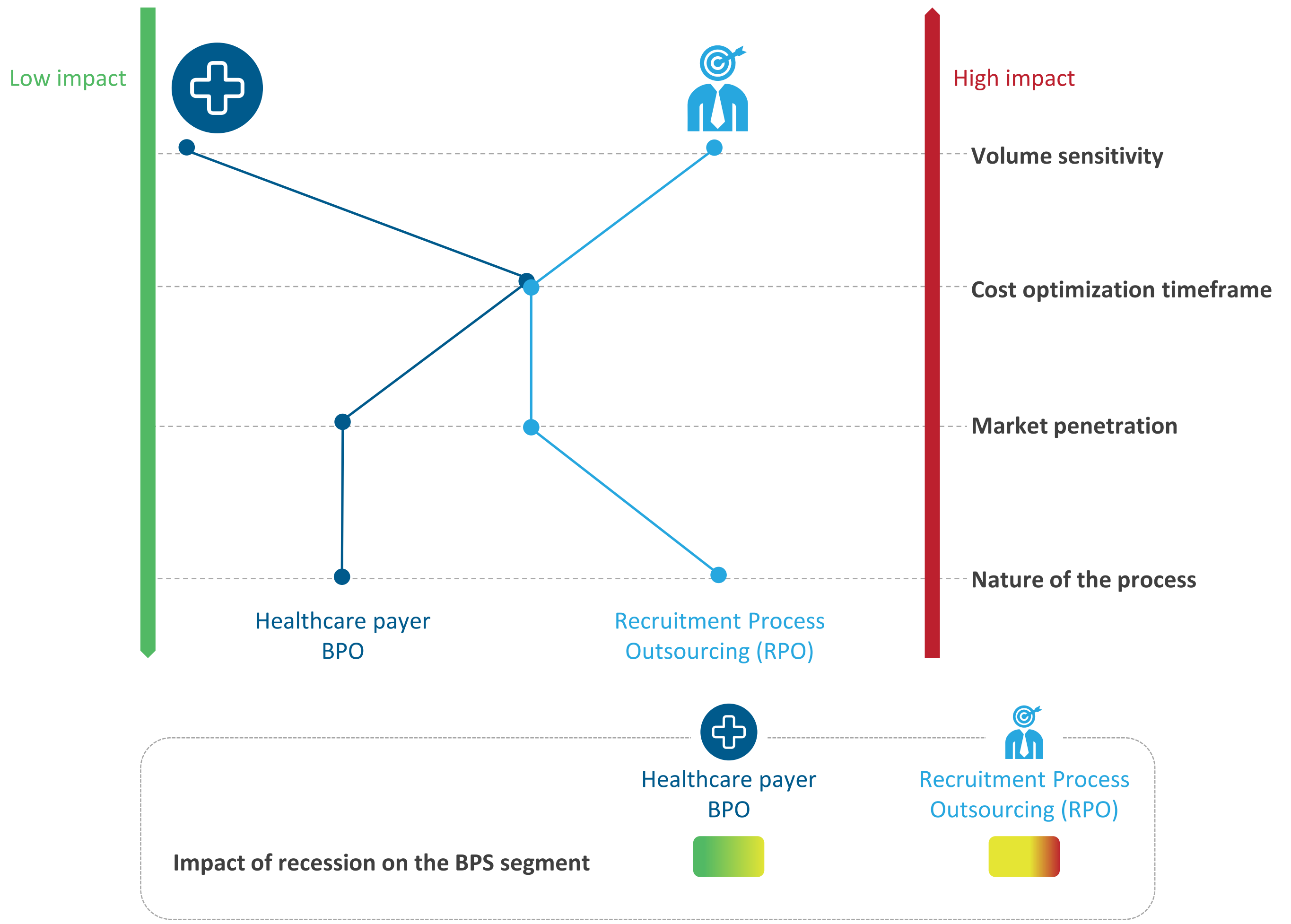


EXHIBIT 7

Comparison of the relative impact of recession on two BPS segments

Source: Everest Group (2020)



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Impact on client portfolio: A service provider's client portfolio is a crucial consideration and plays a significant role in determining the service provider's exposure to a recession. Due to the diversified nature of businesses, service providers will be serving customers across industries and geographies. Identifying the industries or geographies impacted by a recession is key to understanding the exposure of each BPS segment to recession. For example, a provider with a strong financial services industry focus may be more impacted if that industry is relatively more affected by the recession. This can be the case with providers focused on specific geographies as well.

Step 2: Understand the impact on your overall BPS portfolio

After step 1, you will have a clear vision as to the impact on individual BPS segments, which is depicted by the horizontal axis in Exhibit 8. For each segment in which you operate, you need to understand your current market standing, using parameters such as market share, growth rates, and customer base and loyalty.

You can then plot all of the BPS segments in which operate on the impact assessment matrix. (Exhibit 8 offers an example). Segments in quadrant 4 will be the most impacted; those in quadrant 1 will be the least impacted.

Step 3: Understand your financial position and take appropriate steps

Your financial position / cash reserves will influence your strategy. Those providers with a larger financial cushion will have a greater degree of freedom / choices available. However, those that do not can manage well as long as they go through the previous two steps diligently and are prepared to make (bold) decisions.

While financial prudency in terms of managing costs is critical for providers no matter where the segments are positioned, there are key steps that you should actively consider based on the segments' positions and your financial position (see Exhibits 9 and 10).

EXHIBIT 8

Impact assessment matrix

Source: Everest Group (2020)

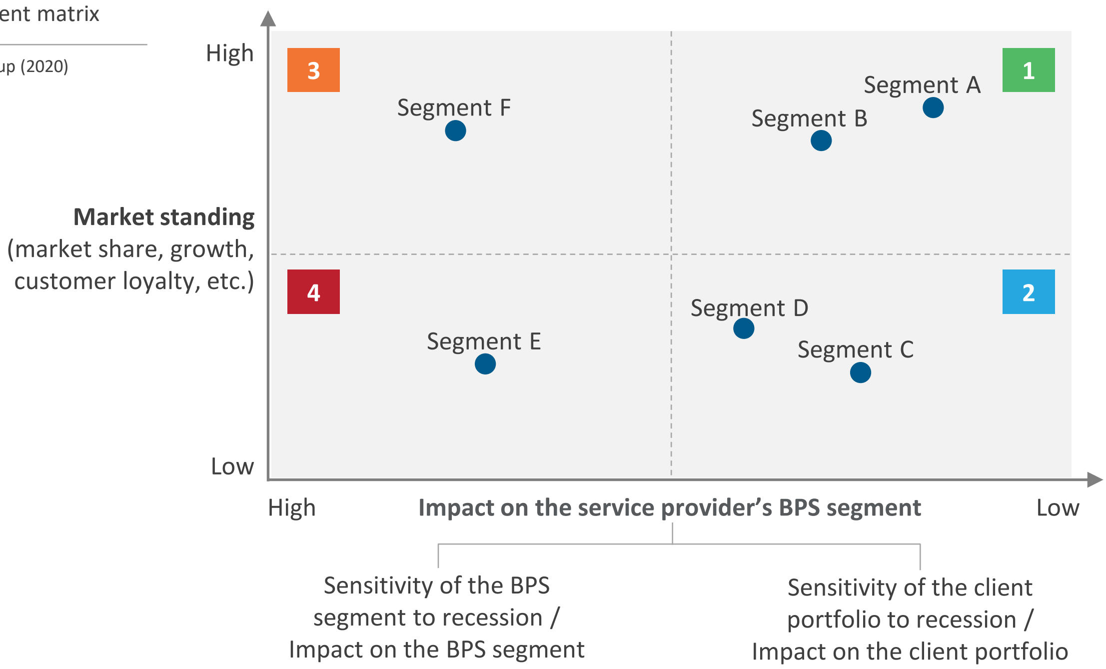


EXHIBIT 9

Downturn strategy snapshot: strong financial position

Source: Everest Group (2020)

Downturn strategy for providers in strong financial positions

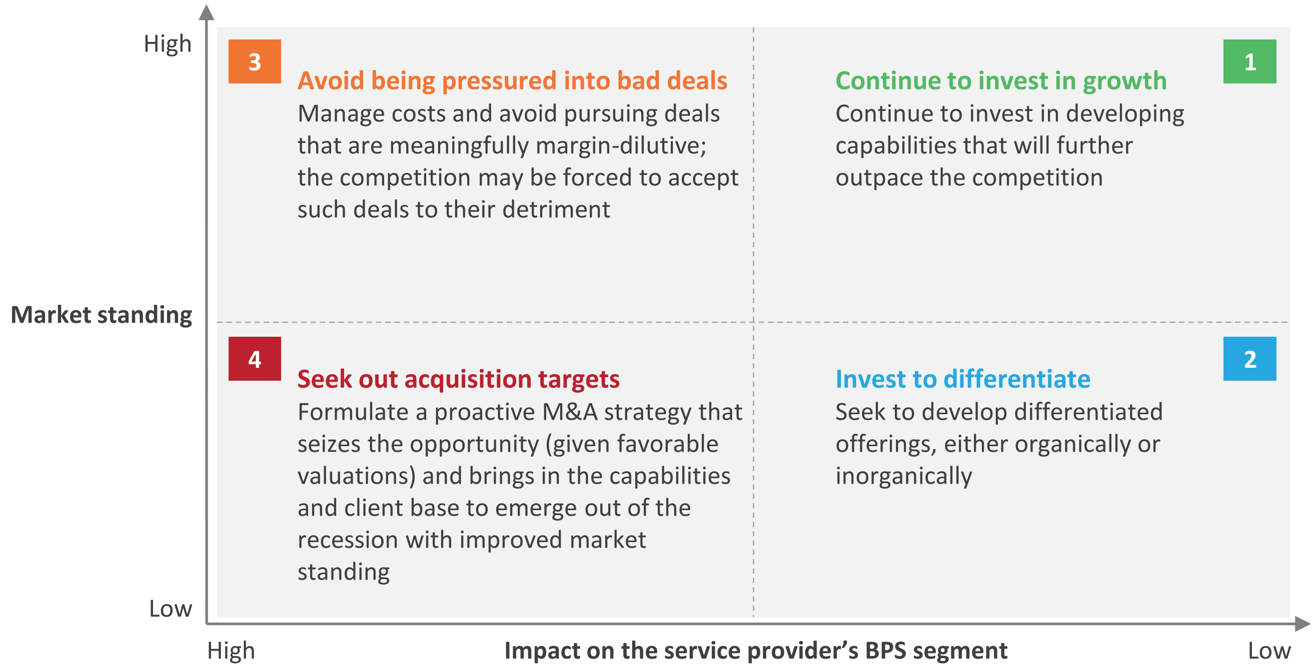
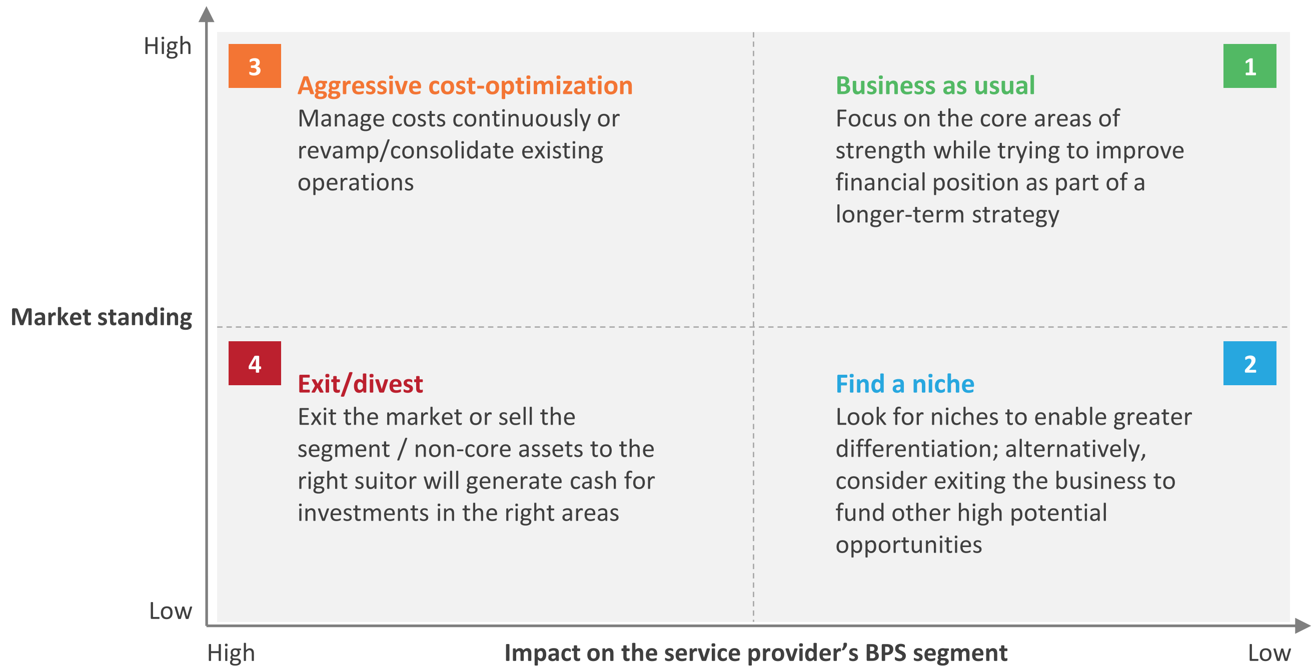


EXHIBIT 10

Downturn strategy snapshot: weak financial position

Source: Everest Group (2020)

Downturn strategy for providers in weak financial positions



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Conclusion

As a service provider, if a recession is imminent, there is no need to panic. Instead, focus your time and effort on developing strategies to thrive through and beyond a downturn. While some may need aggressive transformation in terms of cost and offerings, others can focus on developing capabilities for the future. While recessions tend to be time-bound, the impact on the market and its constituents can be long-lasting. Given this reality and our learnings from the previous recessions, it is imperative for service providers to be prepared. Providers that prepare and take appropriate steps will likely not only navigate through difficult business conditions, but also emerge stronger than the competition on the other side.

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