

Whitepaper
May 1, 2009

Offshoring – Why Foreign Exchange Matters and What to Do About It

Background

According to a recent survey of IT decision makers across 44 industries and various company sizes, nearly two-thirds of these companies are either currently using outsourced, offshore information technology (IT) support, or are planning to do so in the near future. These offshore IT services include the development and maintenance of applications (ADM), the most utilized offshore IT service, remote infrastructure monitoring, service desk support and other critical IT functions. In addition to IT, many companies are increasingly utilizing business process outsourcing (BPO) services provided from offshore locations – including all or part of business process cycles such as procure-to-pay, order-to-cash, and record-to-report.

Offshore services are provided by a combination of foreign outsourcing providers, with most of the larger providers coming from India, which have grown significantly in recent years by leveraging local talent and capabilities (e.g., TCS, Wipro, Infosys, HCL, Cognizant), as well as by U.S. and Europe-based providers who have established significant offshore capabilities as well (e.g., IBM, HP/EDS, CapGemini, Accenture, CSC). While these companies maintain off-shoring support centers in multiple countries, the predominance of off-shoring services are provided from emerging markets, where wages are comparatively low, but access to talent remains available.

While enterprise companies increasingly utilize and rely on offshore outsourcing services, they frequently neglect the currency exchange considerations of these transactions, potentially adding significant financial risk and minimizing the very savings that have been a key impetus to utilizing offshore services in the first place. Reasons for this lack of consideration include: i) procurement and IT buyers being less familiar with foreign exchange issues; ii) the historical savings that have been traditionally available in dollar terms due to labor arbitrage have been

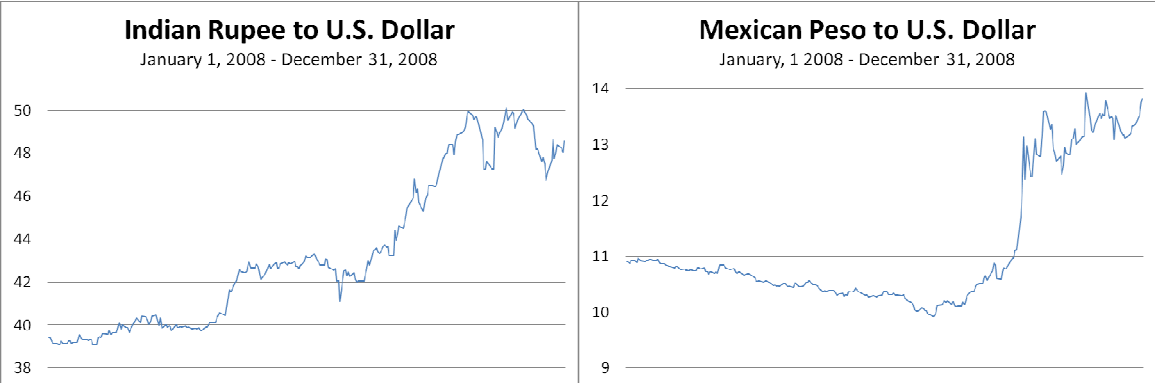
significant enough on their own; and iii) the lack of involvement of internal treasury groups in these types of transactions.

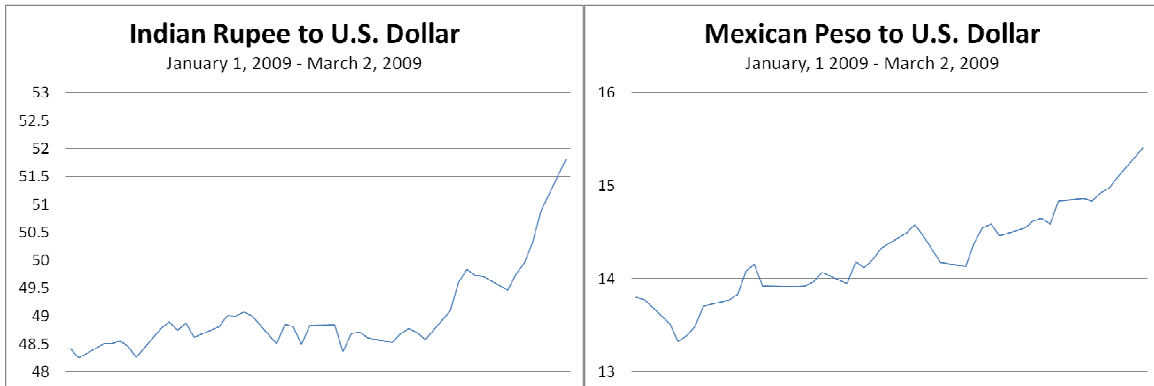
Why Currency Matters

Enterprises entering into offshore outsourcing arrangements too frequently minimize, or frankly ignore, currency implications when sourcing and negotiating these transactions. This is in spite of the fact that the offshore providers are typically delivering services from emerging market locations, and consequently paying their resources (by far the largest of their cost components) in local currency. This currency dynamic can create challenges and opportunities that must be carefully considered, with structures and contract mechanisms employed to align the strategic goals and objectives of the company procuring offshore services - balancing tolerance for risk with the desire to maximize value and savings.

Recent market dynamics have reinforced that currency markets can be volatile, with the dollar having gained significantly over the past year against many major currencies, particularly those of emerging markets. For example, as set forth in the graphs below, from January 1, 2008 to December 31, 2008, the Mexican peso and the Indian rupee lost 26.9% and 23.3% of their value against the dollar respectively. From January 1, 2009 to March 1, 2009, the Mexican peso and the Indian rupee devalued an additional 7.0% and 11.6% against the dollar. At the beginning of 2008, one dollar would buy fewer than 40 rupees; today it buys nearly 50.

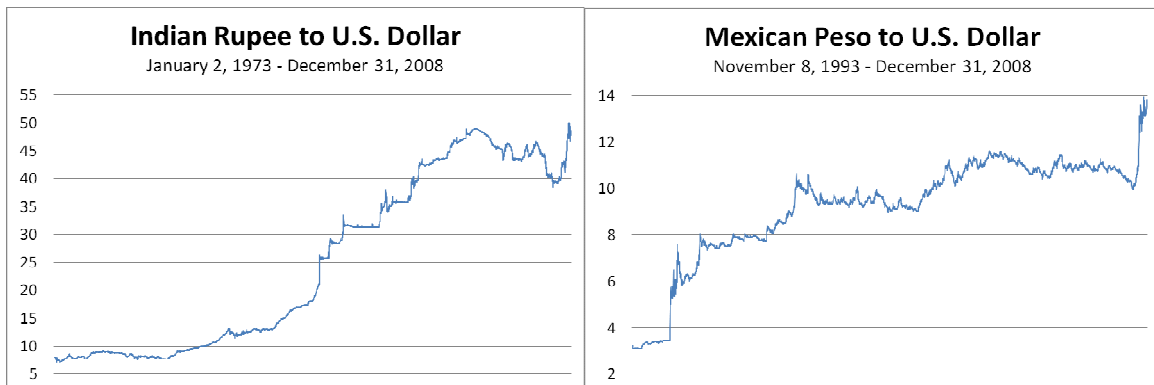
What this means in practical terms is that many offshore providers' costs to provide services have decreased substantially in U.S. dollar terms, while payments received from U.S. company customers paying in dollars for provision of these services has remained the same. So, for example, if a company enters into \$10M contract with an offshore provider, which may cost the provider \$8M to support, the contract now costs the provider some \$6M to support; thereby enabling the offshore outsourcer to capture a \$2M windfall, which limits potential cost savings that otherwise could have been captured by the U.S. customer.



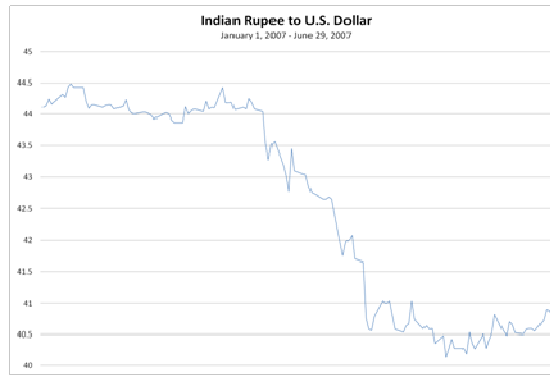


Is the Trend your Friend?

Over the longer term, statistics have shown that emerging market currencies generally devalue against the dollar, with the trend showing significant devaluation over multi-year periods. As illustrated in the charts below, the rupee has devalued some 7x against the dollar over the past 35 years, with the Mexican peso devaluing some 5x over just the last 15 years. This means that the U.S. dollar will very likely buy more tomorrow than it buys today, with the overall trend moving convincingly in one direction.



However, local currencies do not devalue in a straight line; therefore, during certain time periods (which may correspond to a particular contract term) the U.S. dollar may devalue against emerging market currencies such as the rupee. In this case, a contract with payment tied to local currency would end up costing a buyer a greater amount – imposing potentially unmitigated risk. For example, for periods between January and June of 2007, the rupee appreciated some 10% against the dollar, even in this short timeframe. This negative variance could unexpectedly drive up buyer costs, upset established budgets, and leave sourcing and IT professionals with some explaining to do internally.



In spite of these statistics, U.S. companies often fail to consider currency issues when entering into and managing offshore relationships. This is the case even though the dollar's gain can mean substantial benefits for buyers who tie payments to local currency, but can mean substantial costs for those same buyers when the dollar devalues against those same currencies over the short term.

Five Potential Structures to Evaluate

1) Pay in Dollars tied to Local Currency

Paying in dollars, with the dollar payment fluctuating based upon local currency, offers purchasers several benefits, but is not without risks. If a company is paying for offshore labor in a location that has historically devalued against the dollar, then significant savings can be obtained over time by tying payments more closely to the outsourcer's cost of providing the services. These currency savings can offset and eliminate costs such as inflation and cost of living adjustments (COLA) that may otherwise increase buyer contract costs year over year during a multi-year transaction. For instance, if a company pays in a foreign currency at a 3% annual COLA and the currency devalues against the dollar at a rate of 5% annually, the company can retain the extra 2% as additional savings on labor.

This approach also stabilizes the outsourcer's margins on the transaction and thus eliminates the potential situation where the outsourcing vendor is on the "wrong side" of the currency exchange. While availing of positive exchange variances may seem beneficial to the buyer, in practice this may result in service volatility, decreased levels of service, and resource pressures within the account as the outsourcer attempts to recover lost profits due to the currency exchange losses.

A variation of this approach is to pay in the actual local currency. This is typically more cumbersome and costly for buyers unless they maintain a significant commercial presence in the particular local market.

2) Fixed Payment in U.S. Dollars

This approach is basically “no risk, no reward” once the contract is executed. The buyer knows what it is paying in dollar terms, just as with a “typical” contract in the U.S. While over time this approach leaves money on the table, and puts it in the vendor’s pocket, paying in U.S. dollars that do not fluctuate with currency changes ensures the buyer has no exchange rate surprises. Also, if a company believes that the currency of the country where the offshore services are provided will increase in value against the dollar over the agreement term, then executing the deal in dollars will result in favorability to the buyer. Traditionally, most all offshore transactions have been executed in dollars, as labor arbitrage was significant enough that most buyers never considered the incremental currency arbitrage.

Even if a transaction is executed in dollars, without the consideration of currency fluctuations, it is important to remember that the initial price for services in dollars should still reflect any recent, local currency devaluation that may have occurred. For example, the fact that the rupee has devalued some 20% over the past year means that buyers should drive harder bargains in dollar terms, since the offshore provider needs fewer dollars to pay its local resources (again, the vast majority of its costs).

3) Banding

Another method of addressing currency fluctuation is to establish a provision within the agreement that “bands” currency changes in either direction. Typically, the parties will agree to make no change in the fees if the currency change falls within a prescribed band, say 5%, with any changes outside of these bands to be shared between the purchaser and provider. For instance, if a band is set at a 3% fluctuation and the value of the currency changes by 4%, the additional 1% could be shared between the parties so that neither party benefits more than the other from the exchange shift. This middle ground approach provides some potential benefit for the buyer, but mitigates the risk of larger changes by sharing the fluctuation with the outsourcer.

4) Look Back

Another hybrid approach is to take an average of the exchange rate for a prior period (e.g., 6 months or a year) and apply local currency fluctuation against the dollar to the prospective period (e.g., the following contract year). This is then repeated for each year of the contract term. This approach enables certainty of payment during the year after which the “look back” average is applied, and thus can be of particular importance to companies with little tolerance for budget fluctuations within a given budget year. At the same time, the annual re-set, based on this “look back” provides the buyer with the opportunity (and the risk if the local currency appreciates during this period) to capture a lower dollar payment based upon local currency devaluation. A risk is that the “look back” encompasses a period of extreme fluctuation, and the application of that atypical fluctuation creates a future period projection that deviates significantly from the actual currency movement within that period.

5) Hedging

Companies may choose to fix offshore contract payments in dollars, but hedge potential local currency fluctuations. Hedging requires a focused team and can be costly. Costs for any type of hedging lie both in the analysis required to produce a hedging strategy and in the transactions themselves. In order to begin hedging against currency risk using forwards and futures effectively, a dedicated a team of trusted financial analysts is required either internally or externally; additional costs come from brokerage fees and the market prices for purchasing specific contracts. There are also significant costs if on the wrong side of the currency’s movement, as several foreign companies can attest to based upon recent wrong-way bets against the U.S. dollar.



Which Structure Should You Utilize? Additional Factors to Consider

So how do you determine which structure is right for your company? This is generally a function of your company's risk profile, cash flow position, operating margins, and several other factors specific to each corporate organization. In addition to these factors, however, there are certain characteristics about the offshore transaction that also may influence which structure you choose – with different structures potentially appropriate for different circumstances.

Term of the Agreement

When determining exposure to foreign exchange fluctuation in offshoring, the length of the proposed contract can have a significant impact. Because emerging market currencies tend to devalue over time, as described above, longer term agreements may provide buyers with greater comfort in having payments fluctuate in the hopes of lowering their costs during the term (and of offsetting rate increases due to COLA). However, longer term agreements come with operational risks and impingement on flexibility, which may outweigh the potential currency benefits (although this can be mitigated with favorable termination for convenience and no minimum commitment clauses). Short term agreements may provide greater operational flexibility and renegotiation leverage, but they present greater risks in currency fluctuation, since over shorter periods of time the U.S. dollar may lose value against these currencies.

Revenue Generation Location

Collecting revenues in the same currency as the underlying cost can create insulation from exchange fluctuations and provide a “natural hedge.” If a buyer of offshore services also collects meaningful revenues (equivalent or greater than the cost of the services) then it should tie payments to local currency. If local currency devalues against the U.S. dollar, then the buyer company will realize fewer dollars for goods or services sold in that country (assuming it does not have such market power that it can effectively “dollarize” its sales charges). By tying its costs to local currency as well, it will maintain margins. If it continues to pay in dollars, it will squeeze margins as its costs will be dollarized but its revenues in dollars will be reduced. This phenomenon caused several companies to exit Argentina in 2001/2002 as profits evaporated overnight.

For many companies in the U.S. benefitting from offshoring, this method is not possible. Building a significant market in the country housing offshored labor can be costly, complex, and sometimes impossible due to local regulations, market demand, or overall corporate strategy. In this case, it is important to utilize other mechanisms of exchange rate management.

Relative Size of the Contract

Most likely, a company with revenues far outweighing the cost of an offshoring contract will put less emphasis on the importance of managing exchange rate risk. For instance, if the contract in question is for \$100,000 of outsourced work and the company's annual revenue is \$10 billion, then exchange rate fluctuation is most likely not the most important consideration for offshoring. However, if that same \$100,000 contract is part of a significantly smaller company, then exchange rate fluctuation could rate as a primary determinant in its offshoring strategy.

Service Provision Location

Exchange rates fluctuate for many reasons, the most important of which are the relative stability of the government and economy backing a particular currency. When choosing a location for offshoring, it is important to understand the potential political and economic risks facing that country during the term of your contract. If one country offers a small cost benefit over another, but has potential for political instability, the initial savings may quickly disappear in exchange losses (or, potentially, operational interruption).

It is also important to choose a location that holds significant reserves of the currency in which your company operates. If a country has a large enough reserve of your primary operating currency, it is better prepared to maintain a stabilized currency in the long term. Economists at the Bank of England and the U.S. Treasury have suggested that emerging markets maintain foreign exchange reserves equal to their next 12 months of external debt to insulate against currency fluctuation.

Recommendation

While it is nearly impossible to completely remove the currency risks associated with offshoring services, there are many variables that should be considered when developing an offshoring strategy. Too many buyers ignore the importance of currency fluctuation, as well as the associated risks and opportunities. Simply because a company has paid in U.S. dollars in the past and an offshore supplier prefers it that way, does not mean that it is necessarily the best option for the company's strategic goals. Establishing and following the optimal approach requires (i) being mindful of currency impacts; (ii) evaluating potential deal structures; and (iii) applying the appropriate structure based upon internal company dynamics, as well as the particulars of the transaction.