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Chicago • London

TRENDS IN BUSINESS SERVICES 2003

ABOUT THE STUDY

2003 IS THE FIRST YEAR OF A MULTI-YEAR STUDY SPONSORED BY LAKE CAPITAL TO TRACK TRENDS AND CHANGES IN THE PURCHASING OF BUSINESS SERVICES AMONG THE 2,000 LARGEST U.S. CORPORATIONS. TWO PHASES OF RESEARCH WERE CONDUCTED BY C&R RESEARCH WITH MORE THAN 300 EXECUTIVE RESPONDENTS:

- **PHASE I:** 40 initial in-depth interviews were conducted with senior executives substantially involved in decisions to hire outside service providers in four areas:
 - Marketing and Sales (“Marketing”)
 - Finance and Accounting (“Finance”)
 - Information Technology Services (“IT”)
 - Human Resources (“HR”)
- **PHASE II:** A large-scale phone study of 270 senior executives quantified the findings from the study’s initial qualitative phase. The telephone interviews were conducted with senior executives substantially involved in decisions to hire consultants and purchase outsourced services within their respective departments, including:
 - 95 VPs or Directors of Marketing and Sales
 - 75 Finance Executives (25 Treasury Managers and 50 Controllers)
 - 50 CIOs or VPs of IT
 - 50 VPs or Directors of Human Resources

EXECUTIVE SUMMARY

The 2,000 largest U.S. corporations regularly hire outside service providers — from consultants to complete business process outsourcing vendors — to provide services their organizations cannot or choose not to deliver with internal staff resources.

- Marketing (84% of respondents), Finance (75%), IT (66%), and HR (80%) departments engage in the hiring of some type of independent service provider.

With the exception of Marketing, the use of consultants and other outside service providers has remained relatively stable during the downturn in the economy. Furthermore, an increase in organizations’ dependence on external resources is expected in the future.

- While 70% to 80% of executives outside of Marketing have maintained or increased their use of outside resources in the past year, nearly half of all Marketing executives have reduced their level of external resources to some extent due to their companies’ performances in the current economy.
- Those who are currently using outside resources intend to continue doing so, and, with the exception of Finance executives, expect to increase the degree to which they are outsourcing in the next two years.
 - 64% of Marketing executives expect to increase their use of consultants and outside resources, with the biggest budget increases being allocated to external Advertising (26%) and Market Research (18%) services.
 - 30% of Finance executives expect to increase their reliance on a variety of outsourced financial functions, as well as other areas outside of Finance, particularly IT and HR.
 - 50% of IT executives expect to increase outsourcing across several areas, with the greatest emphasis being in IT Implementation and Integration (15%).
 - 60% of HR executives expect their reliance on external consultants and vendors to increase, with the greatest growth being seen in Benefits Administration (40%).
- In contrast, executives across disciplines who do not currently supplement their internal staffs with external resources generally do not intend to hire outside service providers in the near future.

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Phase I qualitative research revealed Marketing departments have a different, and perhaps more advanced, relationship with more of their outside service providers than do other departments.

- Marketing departments have outsourced many functions to a large number of consultants, agencies, and vendors for years, resulting in relationships that tend to go beyond a client-supplier relationship to a more strategic partnership.
- Finance follows a strategic partnership model with banks and auditors, but not with as wide-ranging a group of external providers as does Marketing.
- The qualitative research also indicates that as relationships mature with outside service providers, consultants and suppliers are being sought to take on larger, more strategic projects, particularly by IT departments.

In contrast to the strategic relationship model used by Marketing departments, HR departments are seeking vendors that do not necessarily engage in strategic partnerships with them.

- HR executives are looking to their suppliers to take over administrative functions, so that corporate executives can focus on the strategic aspects of HR.

IT departments appear to be taking a leading role in using international resources for outsourcing.*

- 12% of IT executives surveyed currently use offshore service providers.
- Among those that do not outsource abroad, 20% expect to do so in the next two years.

To persuade executives to use external resources, outside service providers need to overcome two key barriers:

- Cost
- Perceived lack of industry knowledge and/or understanding of clients' specific business issues

Additional barriers to hiring outside include:

- Security/confidential data
- The existence of satisfactory in-house capabilities

These barriers can be overcome by highlighting the benefits of using external resources that resonate most with executives:

- Reduced administrative, labor, and/or capital costs
- Increased access to expertise on a consistent basis
- Ability to get a project started quickly

* Noted in Phase I qualitative responses. Based on Phase I findings, international outsourcing was explored only with IT executives in the Phase II quantitative survey.

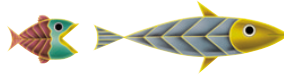
CURRENT AND FUTURE BUSINESS SERVICES OPPORTUNITIES HIGHLIGHTED IN THE STUDY INCLUDE:

DEPARTMENT	OPPORTUNITY
MARKETING AND SALES	Advertising* Market Research Sales Promotion Direct/Database Marketing Services Technology-Driven Marketing Services
FINANCE AND ACCOUNTING	Accounting Related Services/ Auditing* Payroll
IT	IT Implementation and Integration* Software Development PC/Help Desk Support Data/Transaction Processing
HR	Benefits Administration* HR Benefits Consulting Executive Recruiting Compensation Consulting Corporate Education & Training Payroll Processing

* Largest area of growth

Lake Capital is a private equity firm that focuses on investments in services companies across a variety of industries. The firm is currently managing a \$500 million fund and typically looks to invest \$50-75 million of equity in each of its portfolio initiatives to build leading services enterprises through organic and acquisition-enhanced growth.





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MARKETING AND SALES

Marketing executives regularly hire consultants and outside service providers, with 84% of Marketing departments using external resources to supplement their internal staffs.

- Advertising (outside agencies used by 50%) and Market Research (independent companies used by 66%) are the most commonly purchased services.
- In addition, three other areas are outsourced by approximately 25% of Marketing departments: Sales Promotion, Direct/Database Marketing Services, and Technology-Driven Marketing Services.

The downturn in the economy, combined with efforts to save money by bringing services back in-house, has led to nearly half of all Marketing executives reducing their use of outside resources in the last year.

- Nearly 20% have reduced their use of Advertising agencies.
- 10% have curtailed their hiring of independent Market Research companies and Sales Promotion agencies.
- Within the last year, the outsourcing of Technology-Driven Marketing Services has also been significantly reduced. Three-quarters of the 20% of Marketing executives that reported using external resources reduced outsourcing in this area.

The recent reduction in the use of independent service providers, however, appears to be a temporary reaction to events rather than a reappraisal of Marketing's reliance on outside resources, as 64% of Marketing executives expect to increase their reliance on external service providers in the next two years.

In-depth interviews with Marketing executives revealed they were the most likely managers to see their vendors as strategic partners valued for the expertise they offer on core business issues.

- In large part, Marketing departments operate under very strict budget constraints and, therefore, must rely on external resources to accomplish many of their goals.
- Furthermore, because Marketing departments are so dependent on independent providers, and have been so for quite some time, Marketing executives stressed the importance of developing "strategic partnerships" with vendors.
- Moreover, the level of strategic relationship is one of the primary factors on which Marketing executives evaluate their service providers.

To persuade Marketing executives to use external resources, service providers need to prove they can:

- Complement in-house capabilities. Marketing executives are very willing to bring in outside resources to supplement their own staffs, but in-house capabilities frequently are core competencies that vendors cannot match in terms of knowledge, service, or cost.

64% OF MARKETING EXECUTIVES EXPECT TO INCREASE THEIR HIRING OF OUTSIDE SERVICE PROVIDERS IN THE NEXT TWO YEARS.

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- Provide services at a competitive price.
- Become a strategic partner. Service providers that lack industry knowledge or knowledge of a client's business issues have difficulty becoming strategic partners.
- Get up to speed quickly.

These barriers can be overcome by highlighting the benefits of external resources that resonate most with executives:

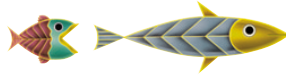
- Increased access to expertise on a consistent basis
- Ability to get a project started quickly
- Reduced administrative, labor, and/or capital costs
- Ability to transfer vendors' expertise to in-house personnel

Looking to the future, Marketing executives expect to increase their reliance on service providers in two key areas:

- Advertising (largest area of growth)
- Market Research

Several other specific services frequently delivered by independent providers were also identified as future growth areas in the initial in-depth interviews with Marketing executives:

- Direct Mail: Developing a mail piece that will increase revenues, a very specialized capability that few corporate staffs or even agencies have, is an area that has a direct impact on sales.
- Data Analysis: Several executives commented that the data they currently have has "barely been skimmed" in terms of analysis. Ideally, these managers are looking for data analysis services that speak directly to business issues and raise red flags.
- Loyalty Cards: Within retail, loyalty cards, which allow consumers to earn rewards for purchases, are becoming core to marketing strategies.
- Trade Show Set-Up and Logistics: Several companies commented that the reason for outsourcing trade show set-up and logistics is because, "we want to spend that time at the conference productively, not setting up the stand and the machine."



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FINANCE AND ACCOUNTING

Finance departments frequently hire external resources, with 75% of departments outsourcing some services.

- Payroll (outsourced by 44%) and Accounting-Related Services (independent companies used by 37%) are the most common services purchased from external providers.
- In addition, five other areas are outsourced by approximately 10% of Finance executives:
 - Risk Management
 - Logistics
 - Accounts Receivable and Collections Services
 - Financial Information Suppliers
 - Facilities Management

Finance departments' dependence on external resources has been relatively unchanged by the downturn in the economy:

- 70% report that the economy has had no impact on their company's use of outside service providers.
- While 16% of Finance executives have decreased their purchasing of outside services, 11% report that the economy has led them to increase their hiring of external providers.

While 30% of Finance executives expect to increase their department's use of outside services over the next two years, 45% expect to see no change in their company's dependence on external resources in the near term, and 21% expect to decrease their reliance on outside providers.

Initial in-depth interviews with Finance executives revealed that, with the exception of their banks and their auditors, Finance departments do not generally have strategic partnerships with their vendors.

- For many within Finance, the hiring of independent suppliers is seen primarily as a means of controlling costs by avoiding excess administrative capacity.
- Finance executives, however, have a different and more strategic relationship with their banks and auditors, relying on their expertise when developing and managing new capabilities. Finance executives also look to banks and auditors for consultative services.

To persuade Finance executives to hire outside service providers, vendors need to overcome three key barriers:

- Purchased services being perceived as too costly or having costs that are difficult to control
- Vendors' lack of industry expertise or a lack of understanding of a company's business issues
- Security concerns

WHILE 30% OF FINANCE EXECUTIVES EXPECT TO INCREASE THEIR DEPARTMENT'S USE OF EXTERNAL RESOURCES OVER THE NEXT TWO YEARS, 45% EXPECT NO CHANGE, AND 21% EXPECT TO DECREASE THEIR RELIANCE ON OUTSIDE PROVIDERS.

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Fall-out from recent accounting scandals has created an additional obstacle to Finance executives' use of external resources.

- Many companies now perform more work in-house to ensure transparency in their accounting, or, to avoid perceived or real conflicts of interest, they have moved from relying on a single accounting firm to several.
- Others are doing more of their own work so that their auditors will not be concerned that an outside vendor has worked on the company's financial records.

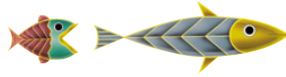
These barriers can be overcome by highlighting the benefits of independent resources that are most important to Finance executives:

- Reduced administrative, labor, and/or capital costs
- Increased access to expertise on a consistent basis

Looking to the future, Finance executives expect to increase their reliance on outside service providers to perform various Finance functions, namely Accounting-Related Services and Auditing, as well as other areas outside of Finance, particularly IT and HR.

Several other specific services frequently delivered by external providers were identified as future growth areas in the initial in-depth interviews:

- Paycards: For employers with large numbers of low-wage employees without checking accounts, paycards, which employers use to deposit wages directly into a debit card account, allow employees to eliminate check-cashing fees while, at the same time, enable the company to cut back on processing fees.
- Online expense reporting: Switching to online expense reports allows companies to eliminate much of the paperwork associated with expenses as well as the need for all direct input from treasury departments, except for the setting up of internal controls for approving expenses.
- Freight and telecommunications billing:
 - Both freight and telecommunications billing involve a high volume of low dollar value payments, making these transactions expensive to monitor for accuracy.
 - Outsourcing freight billing, where a vendor, such as UPS, works out the best routes and consolidates deliveries as a means of controlling freight costs, is also a common first step to a complete outsourced logistics solution. Outsourced logistics systems are costly to implement and involve a large loss of control, however, so implementation is frequently incremental in nature.



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INFORMATION TECHNOLOGY

The use of outside service providers is slightly less common in IT than in other business areas, with only 66% of IT departments using external resources.

Of the seven IT areas identified by the study, no single area of IT is outsourced by more than 28% of businesses:

- IT Implementation: 28%
- Software Development: 28%
- PC/Help Desk Support: 26%
- Data/Transaction Processing: 22%
- Communications: 18%
- Document Information Management: 10%
- Security: 6%

The downturn in the economy has had a mixed impact on IT departments' use of outside service providers:

- 49% of IT executives have seen no change in their spending on outside services.
- 27% have increased their dependence on external resources.
- 24% have decreased their dependence on independent suppliers.

In the near term, however, half of the IT executives who are currently hiring external resources expect to increase their spending on outside services in the next two years.

International outsourcing will be used increasingly by IT executives. While only 12% of IT executives surveyed currently outsource to offshore resources, 20% of those who do not currently outsource abroad expect to do so in the next two years.

Initial in-depth interviews with IT executives indicate that an increased dependence on outside service providers is driven by the increasing complexity of IT services. IT is becoming so complex that it is being increasingly fragmented into various sub-specialties, each of which needs to be handled by different outside vendors.

An increased reliance on outsourcing has led some IT departments to establish more strategic relationships with their vendors. A key requirement to developing strategic relationships is the IT department's ability to proactively manage the inefficiencies associated with outsourcing by:

- Formalizing specifications for required tasks
- Using advanced project management software tools

IN THE NEAR TERM, HALF OF THE IT EXECUTIVES WHO ARE CURRENTLY PURCHASING OUTSIDE SERVICES EXPECT TO INCREASE THEIR OUTSOURCING IN THE NEXT TWO YEARS.

- Training client managers to treat vendors with the respect appropriate for a partner rather than a support person
- Having an agreement with the service provider to continue to provide support for the system once the software has been installed

To persuade IT executives to hire outside service providers, vendors need to overcome four key barriers:

- Purchased services being perceived as too costly or having costs that are difficult to control
- Concerns about access to confidential data
- Lack of industry expertise or an understanding of a company's business issues
- The time required to bring vendors up to speed

These barriers can be overcome by highlighting the benefits of independent resources that resonate most with IT executives:

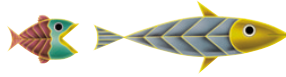
- Reduced administrative, labor, and/or capital costs
- Increased access to expertise on a consistent basis and for high-risk projects
- The transfer of the vendor's knowledge to in-house personnel
- Ability to get a project started quickly

IT executives expect to increase their spending on external resources across several areas in the future:

- IT Implementation and Integration (largest area of growth)
- Software Development
- Communications

The initial in-depth interviews with IT executives identified several other specific services as future growth areas for spending on outside service providers:

- Security and Telecommunications: The hiring of external experts in both these areas is being driven by the increasing complexity of the systems involved:
 - Security: With even off-the-shelf software having bugs and businesses integrating their systems with customers and clients, it is becoming cost prohibitive to keep in-house employees up-to-date on security developments.
 - Telecommunications: Outsourcing the management of telecommunications enables companies to identify savings in the day-to-day oversight of employee calling plans, cell phone usage, email systems, and internal exchange servers.
- Help Desks:
 - Growth in the outsourcing of Help Desks is dependent on companies moving toward increasingly generic software and away from customized company-specific software — not an insignificant barrier — as generic software allows companies to move toward generic business processes.
 - In the near term, some IT directors foresee calls to the Help Desk going initially through an outside vendor. These vendors will classify the problems into areas that will be dealt with either by an in-house staff person familiar with those core parts of the business that have customized IT systems or by an outsourced Help Desk that deals with the more generic software issues.



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HUMAN RESOURCES

Within HR, the use of outside service providers is extremely common, with 80% of departments outsourcing some area of HR.

- There are four areas of outside services that are frequently purchased (by approximately 40%) of HR departments:
 - Benefits Administration
 - HR Benefits Consulting
 - Executive Recruiting
 - Compensation Consulting
- Approximately 25% of HR departments are also hiring external experts for Corporate Education and Training and Payroll Processing.

The downturn in the economy has had minimal impact on HR's purchasing of outside services:

- 65% of HR executives have seen no impact on their use of external resources.
- 25% have responded to adverse economic conditions by increasing their hiring of independent providers.
- 10% have seen the economy and budget cuts force the HR department to rely more on internal staff.

The trend toward an increasing reliance on outsourcing looks to continue. In the next two years, 60% of HR executives expect to increase their budgets for outside services.

However, in-depth interviews with HR executives revealed that HR's enthusiasm for the use of outside resources is not related to a desire for a strong, strategic partnership with vendors. In fact, the opposite is true. Support for outsourcing is driven by HR executives' desire to spend less time managing administrative areas and, instead, focus on a more consultative role strategizing on how HR issues impact their companies' business issues.

The use of external resources is also seen as a means through which HR managers can address the long-term labor shortage facing American companies, a problem HR executives view as having been only temporarily alleviated by the recent economic slowdown.

To persuade HR executives to hire outside service providers, vendors need to overcome several key barriers including:

- Purchased services being perceived as too costly or having costs that are difficult to control
- Vendors' lack of industry expertise or a lack of understanding of a company's business issues

IN THE NEXT TWO YEARS,
60% OF HR EXECUTIVES
EXPECT TO INCREASE
THEIR DEPARTMENT'S
USE OF OUTSIDE SERVICE
PROVIDERS.

continued ➔

These barriers can be overcome by highlighting the benefits of independent resources that resonate most with HR executives:

- Increased access to expertise on a consistent basis or for high-risk projects
- Reduced administrative, labor, and/or capital costs

Looking to the future, HR executives expect to increase their reliance on outsourcing, particularly in Benefits Administration.

HR executives identified several specific services in the initial in-depth interviews as future growth areas for spending on outside service providers:

- Self-Service HR: New Internet-based technologies are enabling employees and managers to get “self-service access” to human resources.
- Background Checks: Background information on applicants, such as court records, is increasingly available online. Consequently, many HR executives are incorporating background checks into their hiring processes.
- Complete Outsourced HR Solution: Ultimately, some HR executives can envision a situation where almost all HR functions are outsourced, especially for smaller companies with less than 100 employees. In these situations, outside HR specialists would:
 - Advise upwards of 30 companies on how to design their HR policies.
 - Actually hire the employees and then “lease” them back to the corporate client.
 - Enable small businesses and entrepreneurs to focus on their core businesses, while leaving the processes of hiring and firing to an HR vendor.