

OFFSHORING: COST SAVING TO VALUE GENERATION

Dr. Rathi Dasgupta

Leader & Council Member,
Gerson Lehrman Group,
Chicago, IL, USA

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Abstract:

This article investigates the current status of offshore captive centres of a few large US-based corporations in India. The original purpose and the current value proposition are analyzed. It also explores the future opportunity for growth of such centres in India.

Research Method:

The identity of the organizations is kept confidential. US-based user IT organizations having captives in India are analysed in two different cities in India. The research is based on qualitative questionnaire and personal and face-to-face conversation with the executives. A quantitative analysis has also been done.

Dedication:

This research article is dedicated to the memory of my mother, Mira Dasgupta, teacher and poet, who is no more and who is the sole inspiration for all my academic pursuits.

Introduction:

IT outsourcing has been going through multiple transition models since the mid eighties of the twentieth century. It started with skilled manpower resourcing, moved to project services and dedicated managed offshore delivery units within the vendor's premises.

In 1985 Texas Instruments created the first wholly owned offshore delivery centre in Bangalore with the help of SR Batliboi & Co., Calcutta (now a E&Y organization). The early success of Texas Instruments persuaded Motorola, Honeywell, IBM and others to move work to captive offshoring in India, giving rise to new competitive dynamics of the captive centre [1],[7]. Until the first half of the year 2000, these captives were mostly for consumer electronics companies. Financial services organizations stepped in a couple of years later. Retail user IT organizations moved in thereafter to set up captive centres for UK and US-based retailers in India.

Initial Drivers and Value Proposition:

Initial driver [1], [2] without any doubt was cost and CFO(s) were the major champions within organizations to promote the idea of the captive subsidiary. CIOs joined the team as the key players for implementation. Acceptance by the business unit heads was a huge challenge for the CFO and the CIO. The arithmetic was the following:

- Total IT budget is X.
- Outsourcing is 70% of X = $0.7X$.
- 70% of the Outsourcing is sent to offshore through a vendor = $0.49X$.

Pricing of offshoring was the following:

- Wage is Y.
- Infrastructure + Overhead cost is 100% of wage = Y.

- Cost of Sales and Marketing is 20% of wage = $0.2Y$.
- Total cost = $2.2Y$.

For a CFO, it was easy to think of the following saving model:

- Cost of Sales and Marketing can be made 0%, making the cost of offshoring to become $2Y$, giving rise to a 10% saving overall.
- Infrastructure cost is $0.8Y$ and that can be amortized over a five year period.
- Cost of wage is not a “one time burn”, one that creates a reusable competency for the next few years, average of three years, even if one accepts a 15% annual attrition.
- The net average cost will be $1.36Y$ for the depreciation / amortization calculation without taking the value of reusable competency.
- This leads to a 38.8% saving for the CFO on offshoring and a total saving of about 19.4% on X .

Raw figures of saving for hiring managers:

US hiring managers used to work on 1:4 to 1:3.5 formulae to replace an US head count with India head count. This formula is still at 1:3 levels at the lowest level of resources including the utilization factors and cost of communication. Cost of communication has come down drastically due to VOIP technology but the infrastructure for serious development work still needs MPLS type connectivity.

Challenges of using vendors for a long term:

User IT organizations become extremely dependent on the vendor and knowledge retention [2], [3] becomes a major challenge [4], [5] for the user organizations. Hence the cost of changing a vendor and the system becomes extremely dear.

Vendors in many circumstances even dictate terms of engagement as the user organization's critical business systems are the vendor's data centre or the data centre is managed by the vendor.

Vendors also have a vested interest to see that the user IT organization does not get enough empowerment and hence question their long term viability as vendors. Many user organizations with dedicated offshore development centres hosted by vendors experience similar conditions.

On many occasions vendors have greater acceptability to the business unit heads than the user's internal IT organization. A captive centre faces this challenge [1], [3].

Life Cycle of a User IT captive organization:

User IT captive organization always starts with the intention of cost saving and also with a low risk non critical resourcing work.

One of the organizations under study (Company A) started with ten resources each with java and dot net programming capability. They used to support some internal corporate websites for handling labour timesheet.

The other organization under study (Company B) started with small programmes for maintenance of some non-critical systems for the point of sales applications for the organization.

After six months of operations Company A had 100 resources working for different projects but still in the same resourcing mode equally distributed between java and dot net skills. After one year Company A had three centre of excellences with java dot net and business intelligence skills. After eighteen months the organization was more than two hundred and fifty people with a centre of excellence as well some business unit projects. Some mission critical and strategic projects started eighteen months after inception.

After twelve months, Company B could become a five hundred strong organization in India with almost end-to-end business projects for a particular business unit and the India head reported to the VP/CIO of a particular business unit directly.

After five years Company A created a mirror organization of the US counterpart and hence has many VPs, Directors and Managers corresponding to the respective business units. Each business unit of the organization is now represented in India offshore and VPs in India own teams in the US.

Company B is trying to follow the Company A. Company A is already handling a few thousands of employees and vendor contractors with IT and Business Services represented therein.

Company C under our study also could grow to a three hundred member organization but the parent organization decided to hand over the ownership and control to one of the large IT services vendor with a five year contract of continuity of business.

Empowerment of the Captive Centre:

Captive centres on most occasions are also managing all of the offshore vendors. A captive centre plays a major role in programme management of offshore projects and in the negotiation of pricing with the offshore vendors.

Captive Centre (in case of Company A in our study) is no longer “an extension of US HQ” but itself empowered to take decisions independently. Company A has people at the SVP level poised to become CIOs in a few years.

Number crunching:

- Blended offshore cost lies in the range \$14 to \$34 depending on the size of the captive, infrastructural investment and utilization level.

- Investment on India offshore varies between \$10m to \$100m+ (in our study Company A falls in the higher bracket of investment and Company B falls within the lower limit). Most captives for UK-based multinationals stay in the range of \$12m to \$25m.
- Cost of using the outsourcing vendor for company A is around \$31/hour offshore and \$55 to \$75/hour for onsite in US.
- Company A negotiated 30% lower rates with the offshore vendors.
- Company A pays the key executives salary in the range of \$150K to \$500K per annum.
- Company B pays the key executives salary in the range of \$75K to \$120K.

Value generation at the Captive In-sourcing Centre

Other than the typical benefits [7] of lower cost and availability of skilled resources, a captive centre creates the following short term and long term value propositions:

- Consolidation of outsourcing vendors.
- Near shore programme management for offshore vendors.
- Greater competition and quality improvement of vendor delivery.
- Better negotiation of pricing for outsourcing deals.
- Alternative disaster recovery options.
- Availability of diverse talents at short notice.
- Easy availability of resources to do “Proof of Concept” experiments and test new “idea projects”.
- Creating re-usable competency owned by the organization.
- A captive centre can work collaboratively with the vendors to create new technology and business competency.
- Knowledge is retained in-house and vendor dependency is reduced.

Model that works

Research shows that a collaborative model [4]. [6], [7], [8] works best. One needs to have a combination of in-house captive offshore, vendor capability and resource suppliers. Having a standalone captive poses a great risk to the organization's business as the captive centre becomes a single point of failure. It also typically takes a period of five years before the captive offshore can independently run projects and assumes leadership.

Conclusion:

It would appear that a mature captive offshore creates a different value proposition for the parent organization if proper empowerment of the offshore is ensured. The benefit is no longer in saving of cost, but in generating a long term value.

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