

# How to Go Offshore – Set up a Captive Unit or Outsource?

By Mahesh Ramamani

**Executive Briefing:** Firms today are facing increased pressure from shareholders to cut down costs of operation and one of the ways firms have cut costs effectively with limited changes to their strategy is to look at offshore production of firm's activities. While outsourcing firms offer easy offshore solutions in well developed and defined markets, firms are increasingly investing in establishing a foreign subsidiary in a low cost offshore location with a view to withholding control of processes and knowledge of their critical activities. Hybrid arrangements involving a combination of outsourcing and captive unit strategies are also increasingly becoming common. How does a firm know which is the best way to go offshore – setting up a foreign subsidiary in an offshore location or engaging with an offshore based outsourcing provider? What are the considerations that managers take into account while they make this decision? What are the enablers and barriers in either of the strategies? These are some questions that I will try to address in this article.



Though companies adopt offshore strategies motivated by cost optimization reasons, managers reflect on the performance of offshore engagements along two dimensions – 1) Efficiency of operations and 2) Value of operations. Efficiency of operations is related to what measurable output is obtained from the offshore engagement as compared to the cost encumbered for the same. It includes factors more specifically as cost of operations, cost per seat / employee, utilization rate and process productivity. Value of operations on the other hand is related to the value add provided to the engaging firm in terms of vertical scope and forward integration benefits like faster processing time, robust quality process etc. Value of operations is also associated with intangible benefits like complementary benefits arising out of home operations and offshore operations like increased access to capability and talent and high scalability in the business model.

In our study, we conducted a semi-structured survey of captive units (foreign subsidiaries) operating in India and business process outsourcing providers primarily in the financial services industry and collected qualitative data pertaining to the offshore operations. We followed this with an in depth case study of a few captive unit operations and few outsourced operations. We set out to understand based on this data, the structural differences between captive unit operations and third party engagements, how each of them mature over a period of time and over their maturation time frame, what are the boundaries that govern their operations and what are the barriers each of them faced. We obtained key insights into the conditions under which captive units are setup,

the dynamics that guide their maturation process and corresponding conditions for third party engagement.

## Takeaway

Going offshore by engaging third party business process outsourcing providers is normally an activity that is moderated by the purchasing department and hence is high in its stress on contract quality and completeness. Managers of firms that outsource look at clearly measurable, contractible metrics for assessing performance especially while engaging with third parties. These metrics are typically outcome based and measured after the execution of a business process like customer call conversion rate, or customer call resolution ratio for a customer support call center activity. However, when managers of a firm engage with their foreign subsidiary counterparts, the stress on monitoring these measures is significantly less. Instead, their main concerns are about how well the employees in the foreign subsidiary understand and appreciate a given business process. The zeal that managers show towards the qualitative aspect of process execution in a captive unit limits their ability to monitor and manage the efficiency of their operations. Hence, captive units turn out to be relatively less cost - efficient options in the short run.

Also, the maturation paths of a 3<sup>rd</sup> party outsourcing relationship and a captive unit operation are strikingly different. Third party relationships initiate as arm's length contracts with high efficiency focus and low value focus; they move gradually towards converting themselves to be a higher value adding engagement aided by the learning processes that occur over a period of time. And captive unit operations initiate as tightly

integrated units with little focus on efficiency and gradually move towards a more efficient structure. Figure 1 shows the relative maturation paths of captive units and outsourcing engagements.

### Third Party Engagements

Third party engagements typically originate with efficiency as the focus under the expectation that the vendor possesses superior production cost advantages or scale advantages which may be instantly appropriable. Firms function with clearly identified boundaries where the third parties may operate and typically bear the brunt of integrating the result of their operations into their value chain. Thus, engaging a third party for offshoring operations may externalize or disintegrate the activities in the firm's production value chain. As the engagement with a third party vendor matures and the trust with the organization grows, firms tend to expand the portfolio of their engagement. The expanded engagement outlay now encourages the vendor to invest in high quality resources in the relationship with a specific view to increase the integration between the off-shored operations and the firm's value chain. However, since such value integration happens in special areas, the vendor squeezes out a higher margin thereby eroding the overall efficiency advantage. Thus, the zone of origination of a third party engagement is in the second quadrant and its trajectory of maturation moves gradually downwards from the 2<sup>nd</sup> quadrant to the first quadrant (as depicted in Fig – 1).

One of the key challenges in the maturation of a third party engagement is that of knowledge barriers. Out of fear of lock-in with a specific vendor and fear of losing important knowledge critical to the firm, companies would not share knowledge of the production process of the firm with the vendor very easily. This knowledge barrier disables the vendor from offering greater vertical scope to the client's operations, thus imposes a ceiling on the possible value of services provided. Knowledge barriers arise from proprietary and complicated processes that a firm tends to nurture, special process steps that the firm believes differentiates it from its competitors. As such proprietary processes get replaced with standardized processes, the scope of entry for third party players into these segments increases. As this happens, the knowledge barrier ceiling will be pushed further to the right.

### Captive Unit Operations

When a company sets up its captive unit operation in an offshore location, efficiency related factors are not the only ones that drive the charter of the offshore location. In fact, it has been established that setting up captive unit operations are typically costly involving huge front-end investments. The charter for the functioning of the captive units is based on the type of processes to be adopted for offshore execution and the level of integration that the captive unit would have to

achieve in each of these processes. Thus, we see that the value dimension of operations is the central driver of a captive unit operation. As the captive unit operation expands, it also gains scale advantage and thus improves in the efficiency dimension as well. Thus, the zone of origination of a captive unit is in the third quadrant and gradually moves towards an increased value of operations and also an increased efficiency in operations. Thus, we may see some captive units mature along into the first quadrant while some captive units mature into the fourth quadrant (as shown in Fig – 1).

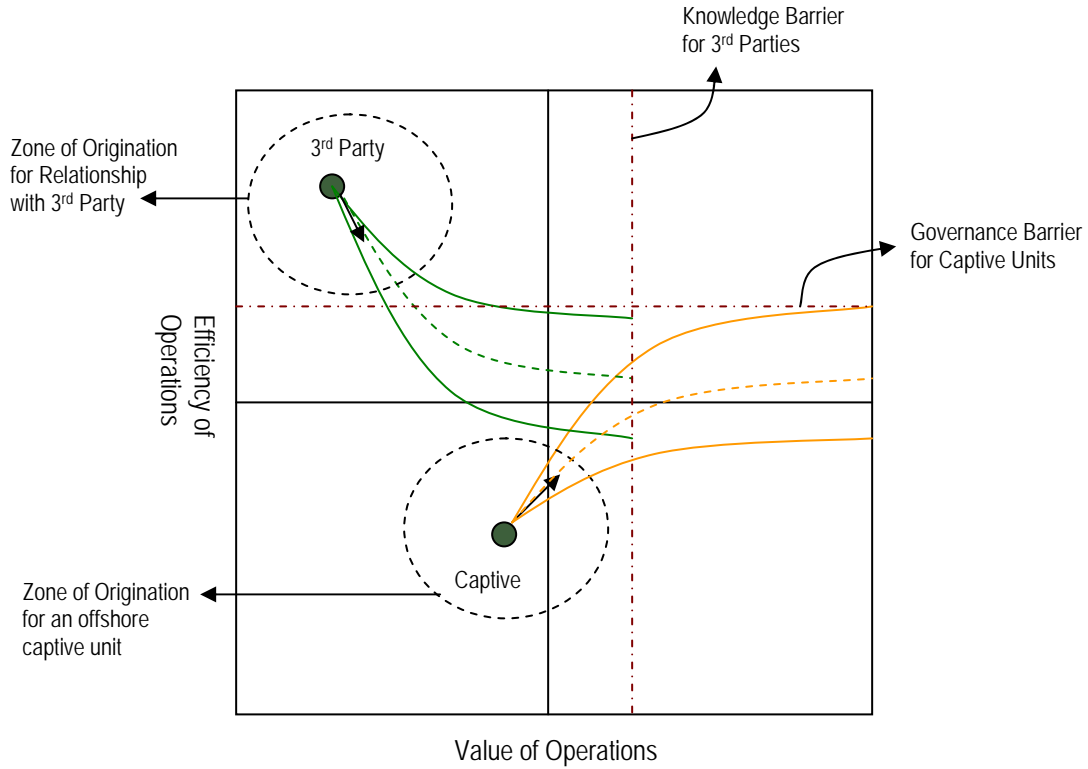
One of the key challenges that a captive unit faces in its maturation is governance barrier. As captive unit operations are governed by a charter focused on value rather than efficiency, its costing and budgeting mechanisms tend to be loose and thus give rise to some inefficient cost centers of operation. Hence, captive units by design face a ceiling on the level of efficiency of their operations. However, due to learning effects over a period of time, some captive units are able to enforce stricter governance based on tighter control. Such improvements in governance would help in pushing the efficiency ceiling upwards for a captive unit.

### Conclusion

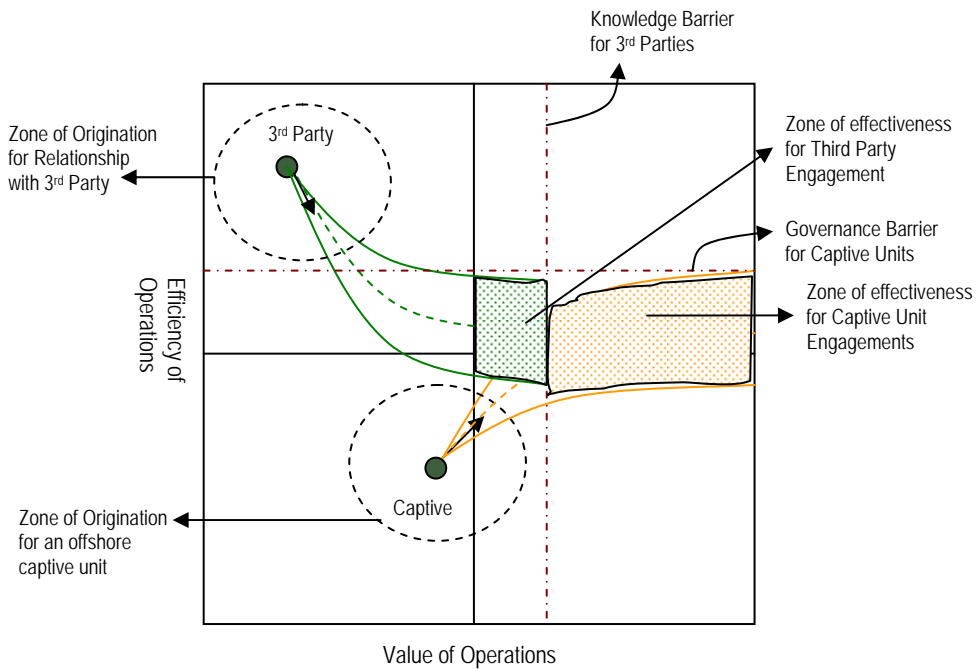
Since efficiency is the central driver of 3P engagements, the maturation trajectory of a third party outsourcing offshore arrangement is along the high efficiency space offering unique combinations of value and efficiency that may not be achievable by an offshore captive unit. The depiction in the figure – 2 explains the possible area of unique third party engagement effectiveness in the value – efficiency space. Alternatively, forward integration benefits form the central driver of captive unit operations and the maturation trajectory of a captive unit is along the high value space. This offers certain levels of unique value benefits at non-contractible efficiency levels that may not be achieved by a third party offshore outsourcing arrangement. This zone of effectiveness of captive unit operations is also depicted for explanation in figure – 2. Knowledge of the enablers and barriers of market based and subsidiary based offshore arrangements thus leads us to understand an optimal offshore strategy that may suit the needs and requirements of a firm. It is essential to appreciate that the focus of third party based offshore engagements and offshore captive units are thus fundamentally different and should not be looked at as substitutes. While defining offshore strategy of a firm, it is important to understand the main goal of the offshoring effort – the targeted area in the value – efficiency continuum and based on that the corresponding offshore strategy should be decided.

◆ gBR Article 03-05, Copyright © 2009

**Figure 1**



**Figure 2**



**About the Author**

Mahesh Ramamani is a Research Fellow of Center for Leadership of Digital Enterprise at the Eli Broad College of Business, Michigan State University where he is pursuing his PhD in Information Systems and Strategic

Management. Prior to his academic venture, he was the Strategic Advisor for Netweaver at SAP India Pvt. Ltd and has over eight years of experience in Enterprise Application Integration. He could be reached at [ramamani@bus.msu.edu](mailto:ramamani@bus.msu.edu).