

## **Captive Units Vs Third party players out in BPO battle**

*While going the offshore way is not a hard decision for many global majors, deciding on which approach to take certainly is. Organisations are divided on whether to set up a captive unit or outsource to a third party service provider. **Stanley Glancy** takes a closer look at the scenario in India*

History oft repeats itself, they say. If the current trends in the information technology enabled services industry are anything to go by then history is certainly being repeated. This time it is the BPO industry. The odyssey that began with the West's discovery of India as a low-cost, high-quality IT services destination took a new turn when a few industry majors decided to experiment with offshore outsourcing of non-core processes and customer service-related activities to centres in India. The agenda was quite obvious—to cut costs, and wherever possible, to improve process quality.

There has been no looking back since then. An increasing number of aggressive Fortune 500 companies realised the huge cost saving potential and began outsourcing non-core processes to India. It started with the setting up of wholly owned subsidiaries by the likes of GE and British Airways. This was soon followed by the entry of Indian third party players, either in conjunction with established players from the West or with the backing of venture capitalists. And as was the case with the IT services (ITS) industry, players realised the benefits of outsourcing to third party service providers (TPSP) over investing in captive units.

But in the race for market share India is now fast becoming a battleground with two clear sets of players emerging—the giant multinationals (the likes of GE, Prudential, HSBC, etc) versus the new emerging class, the third party service providers, which include the likes of Daksh, Tracmail and Wipro Spectramind. While both classes of players have their positives and negatives it would be interesting to find out how this industry will eventually evolve.

### **Who will win?**

The more conservative companies in the West have also gradually awoken to the realisation that outsourcing is no longer a fad, but rather a prerequisite for survival in competition between global majors. And for most of them India is the preferred destination. But here the trend has deviated from what was seen in the ITS industry. Being conservative these companies were reluctant to outsource their IT needs and processes to a TPSP, the path taken by many of the global majors.

Need for absolute control over processes thanks to fears over the chances of intellectual property being compromised prompted most to set up captive units instead of taking the beaten path. Even some of the early adopters preferred keeping critical activities within the organisation while outsourcing non-core activities, a route taken by the likes of American Express, HSBC and other financial services companies. Says Ravindra Datar, principal analyst for Gartner India, "Some companies in the US are convinced about the benefits of going offshore and of using India as a base for global requirements, but are not comfortable outsourcing to external service providers. These companies prefer to set up their own captive units to gain from the benefits of offshoring."

This, in turn, has put pressure on TPSPs to cut rates, thinning margins further. TPSPs have indirectly lost business that would otherwise have been available to them. So

what's in store for the Indian BPO sector? Will we see the market being ruled by the captive units or, as in the case of the ITS sector, will Indian third party service providers emerge winners?

### **The numbers game**

In 2002-03 the Indian ITeS sector grew at a rate of 59 percent and clocked revenues of Rs 11,300 crore, up from Rs 7,100 crore (\$1.5 billion) in 2001-02. The industry is projected to register a growth of 54 percent to clock revenues of Rs 162 billion (\$3.6 billion) in the 2003-04 fiscal. Amazing figures. But there's more to come.

A report published by IDC states that worldwide spending on BPO may increase to Rs 54 trillion (\$1.2 trillion) by 2006, growing at a compounded annual growth rate of 11 percent year-on-year. Worldwide spending was approximately Rs 32,040 billion (\$712 billion) in 2001. Another study conducted by Forrester Research estimates the US BPO market to grow to Rs 6,570 billion (\$146 billion) by 2008. Elaborates John McCarthy, group director

of Forrester Research, "Approximately three million jobs will be created in this space by 2008. Up to 40 percent, or one million, of these jobs will end up offshore." India stands to get a sizeable cut of this pie if we play our cards right.

In terms of cost savings that a company can accrue, India is far ahead of any other competing region. According to another study, the 45-55 percent cost saving enabled by setting up a centre in India is significantly higher than the APAC average of 40-45 percent. And while Mexico and other Central American countries offer 35-40 percent savings, the numbers fall significantly once we move westwards. Canada, which is the preferred destination for many US companies for near shore operations offers only 20-30 percent cost savings and this comes down even further to 15-25 percent on reaching Europe.

Besides cost, there are several other factors, which can influence a decision in India's favour. According to Nasscom, Indian companies offer 20 percent higher productivity in comparison to other competing countries like Philippines, Canada and Australia. Even in terms of quality offered India stands 30 percent higher than any other region. The fact that almost 60 percent of the work undertaken is repeat business further strengthens the argument in India's favour.

But captive units have snapped up a major portion of the business. According to studies conducted by Nasscom, captive players have almost doubled their share in the Indian ITeS space, growing by a phenomenal 90 percent. From \$710 million in 2001-02, captive units have crossed \$1350 million this year. This is not to say that third party vendors have taken a hit. Though not in the same scale as the captive units, TPSPs registered significant growth. From \$769 million in 2001-02 they touched \$985 million in 2002-03. Absolute growth increased from \$549 million in 2001-02 to \$856 million.

But when it comes to new investments both captive units as well as third party players have attracted an equal share. The quantum of new investment in the industry increased by around \$300 million to reach \$800 million by the end of 2002. Most of the investments by third party players have been in infrastructure development.

### **Freedom in captivity**

So what is a captive unit all about? There are various types. The larger companies might see huge benefits in moving processes to a different geography in order to avail of cost benefits, and if possible improve processes. But not all companies wishing to have a captive unit have deep pockets or international experience. Such companies might either enter into a joint venture agreement with a player having BPO expertise or they might even enter into a build operate transfer agreement.

Many companies are uncomfortable with the idea of outsourcing to a TPSP due to two main reasons—as mentioned earlier, the company might have certain intellectual property, which it doesn't want to fall into outside hands. Also, the outsourcer may not be convinced about the TPSPs capacity to handle the volume of activity that needs to be supported. Security and privacy issues are other key factors.

The larger companies with deep pockets and the ability to wait out a few years before seeing any return on investment might set up a captive unit to handle non-core processes. Typically, captive units look at a payback period of around 3-4 years. This reflects a capability to sustain all initial capital and recurring costs. Most of these captive units are cost centres, and have not been established with a view of churning out any profits.

But some leading firms companies have adopted a mix of captive and outsourced services wherein some of the more complex and core processes are being handled by the captive unit. Credit card companies, for instance, have complex technologies in place to analyse customer behaviour. Around 20 percent of their people would be involved in analysing customer behaviour. This is one section they may never outsource.

Explains R K Rangan, managing director, Prudential Process Management services, "Insurance is a complex business with highly regulated processes. Over a period of time we have evolved various processes, which provide us with a competitive advantage. A third party can redeploy the expertise. We have a comfort level as the assets remain with us. Also, the jobs go to our own company. And we get to capture the margins, as much as 20-30 percent, that would otherwise have gone to a third party."

Says Prakash Gurbaxani, CEO, Transworks, "You may want to opt for a captive unit to mitigate risks and to ensure that your IP is not compromised. What is happening is no different from how this industry has evolved worldwide. Most large companies outsource some work and keep some in-house. For large companies the risk involved in investing in a captive unit is less. And in case demand goes up they can also ramp up faster than a TPSP."

Additionally, availability of fully-owned multiple sites across various countries in Asia enables these organisations to continuously innovate, re-engineer, and re-migrate processes within the region. This provides them with a strategic perspective and also the opportunity to spread risks, ensuring better business continuity and disaster recovery.

Says Avinash Vashistha, co-founder and managing director, neoIT, "Other than cost savings, the necessity of bringing together currently disintegrated processes that serve similar product lines in various countries is becoming paramount. Companies are also facing shrinking bottom lines, time-to-market issues, and they need flexibility to continuously innovate and serve customers in real-time across all time zones. Owing to the nature of such decisions and strategies, management control

assumes paramount importance, which cannot be devolved to a third-party supplier. Investing in a captive unit becomes the one viable approach to ensure long-term business gains, and enhance competitive edge.”

Says Atul Kunwar, managing director of E-funds, “A captive unit understands the pains and the dynamics of the outsourcing parent company. It can understand the issues involved in knowledge transfer, employees losing jobs, etc. This enables them to talk in the customers’ language since we have ourselves faced these issues. TPSPs, on the other hand are insensitive to such issues, as their sole agenda is making profits.”

But being a cost centre can also have a negative impact as captive units can lose touch with market reality. TPSPs constantly innovate and improve processes to cut costs, driving down market rates. The captive unit might be oblivious to the current market rate and might be missing out on opportunities to cut costs further.

Also, Kunwar feels that as workload increases the captive unit might have to face irrational demands from the parent company. In its effort to keep costs down the management might not think it beneficial to invest in a lot of bandwidth or set up new centres to handle the load or hire more people. This might in turn have an adverse impact on efficiency and productivity.

Also, the scale and size of some of these organisations has helped in developing and nurturing excellent managerial

and decision-making talent. Complete ownership of the outsourced entity offers outsourcers the flexibility to retain and productively redeploy this talent, rather than losing out to competition.

### **The insider**

Companies that do not have the comfort of sustainable cash look at outsourcing as a definite strategy too. Approval for capital expenditure is a convoluted procedure in most companies. Hence, most companies prefer conserving capital for investing in core activities instead of in setting up a captive unit. This is one of the key reasons why they outsource to a third party.

These companies look at short wins, and long-term savings. Such needs can only be satisfied if the organisation does not have to invest in the very involved and costly exercise of business analysis and the outsourcing flexibility they have. An efficient and proven supplier who has the capability would suit their purposes better. Says Gurbaxani, “Not all companies are global. Such companies will have to invest outside of their environment. A strategic decision to open a centre in another country and the costs involved is a long drawn process. A TPSP on the other hand can be up and running in less than 90 days.”

Adds Aniruddha Joshi, director and head of strategy, Zenta Group, “The second rung of companies do not have the management talent or the financial muscle to set up captive units. But they have seen what the large companies with whom they are competing with have done and cannot afford not to outsource.”

Outsourcing to external service providers helps the organisation in focusing on core business issues. It also ensures that the organisation benefits from best-of-breed solutions rather than depending on internal staff that may not always be the best

team capable of delivering the required services. Outsourcing to external service providers brings out hidden costs and makes it easy to monitor and manage expenditure. It also adds flexibility to operations since the number of people working on the specific job or the infrastructure dedicated can be changed and paid for accordingly as per changing requirements, without having to suffer from the burden of excess capacity or the challenge of insufficient capacities.

External service providers if selected properly can deliver better quality of work at even lower costs than done internally due to better process maturity, resource flexibility and economies of scale.

Says Rahul Kanodia, managing director of Datamatics, "While there are companies who believe in core competency others believe IT processes are crucial to their operations. But as long as an external service provider respects the customers' intellectual property rights, they shouldn't face a problem."

TPSPs are also more committed than a captive unit when it comes to commitment on price and adherence to quality, as outsourcing is their bread and butter. Their very existence depends on work being outsourced.

And being a profit centre, a TPSP will be proactive rather than reactive. They will also invest considerably in building better processes and developing expertise. Outsourcers can also provide benchmarks to captive units. And being much smaller TPSPs can implement newer technology faster. But TPSPs will have to prove their financial stability and sustainability to the outsourcing company.

Third party companies who don't have the process expertise will lose out in the long run. But those who survive will add capabilities and processes. Says Kunwar, "Our advantage is that the business enjoys good support within the country. There is recognition of the fact that we are delivering. It has become a mainstream trend. It is not just cost arbitrage but improvement in processes that we can provide. And with advancements in technology and telecom the risk today is much lower."

### **My non-core is your core**

One common complaint has been that most multinationals prefer to outsource non-critical, non-core activities to third party service providers while preferring to employ captive units for core activities. There has been a basic issue about classifying what is core and critical, what is critical but not core and what is neither core nor critical. Lack of proper understanding of this led to companies outsourcing only things that were very obviously non-core and non-critical, which in turn deprived them of the full benefits of outsourcing.

But issues of core and non-core cannot be understood without understanding what is core to an organisation. It is important to identify what the source of competitive advantage is for the client. What may be a critical function for one organisation may be non-core to another.

That's not to say that the work being outsourced is unimportant. For instance, most companies outsource processes like customer service management, accounting, human resource management and transaction processing. Though these functions may not be core to the company's activities no company could afford to dismiss them as unimportant and non-critical. But outsourcing these functions enables the company to focus on its core activities and improve organisational competence

There are also issues of aversion to give up direct control over processes and about security and privacy of information. As the business environment continues to become more and more challenging and centred on intellectual property and the knowledge domain, security is very important for organisations.

Says Vashistha, "Only captives can effectively provide enhanced security for data and processes. Ideally, companies should outsource their non-core processes to TPSPs, while retaining critical core activities within a captive unit." Captives have been set up to keep all core and non-core activities within, while leveraging on reduced operational costs, and improved quality. This results in a lack of management focus on core activities. More or less, all activities, core or non-core tend to see some complacency creeping in, much of which can be attributed to a detached and laconic view of managing a captive unit. Usually this could result in a very conservative attitude to embracing change.

But Datar differs on this point. Says he, "It may not be right to assume that information is secure just because it is controlled in-house. In some cases systems and processes set up by internal staff may not be as secure as an external expert can provide simply because the internal staff may not have the necessary expertise in that area. An external service provider may be able to provide a more secure and stable environment by virtue of their expertise that internal staff may not have."

### **Tertiary bonus**

Whether to have a captive centre or not is a business decision in the end. Both captive units and TPSPs will grow together as different companies have different propensities. Many of the larger companies might opt for a dual approach.

Almost all experts that Express Computer spoke to felt that the cost advantage will soon be lost. This will force Indian third party service providers to come up with innovative solutions and look at different ways of doing things to increase productivity.

Captive units have an advantage over TPSPs when it comes to attracting talent, as they come with a brand name. So from a recruitment point of view TPSPs would have to invest in brand building to attract good talent. But third party vendors stand to gain from the experience of employees shifting from multinational companies.

Even from a macro economic point of view setting up of captive units can benefit the Indian economy, as it creates plenty of job opportunities. And having captive units helps to build the India brand name, making it easier for TPSPs to attract customers in the international market.

Captive units also present the challenge of competing for resources. This can motivate or rather force Indian companies to move out of the major metros to smaller towns in order to save costs and also focus on delivering better quality. This in turn creates opportunities in these smaller towns.

All players feel it is a good thing for Indian companies to face stiff competition. Some will suffer but those who survive will emerge stronger.

### **Going forward**

Says Vashistha, "Third party service providers (TPSPs) shall continue to be an integral part of this industry. However, one may note that large-scale outsourcing commitments shall remain within captive centres, because of the nature of control and complexity of product lines."

While cost saving is one of the major decision motivators, service providers should think beyond costs, while developing and demonstrating their competitive differentiators. There is a need to build and demonstrate processes and domain expertise and the processes and infrastructure set up to address their potential client's key concerns about quality of work and security of information. They need to develop innovative non-cost differentiators and communicate clearly to the client how they can deliver business value relevant to the client. They need to demonstrate capabilities by which they can provide their clients with long-term strategic benefits rather than focusing on short-term, cost-based competition.

According to Gurbaxani, captive units will constitute more than 50 percent of the outsourcing business over the next few years. "Even in a mature market like the US 80 percent of the work is captive," says he. Mature captives will become profit centres in the times to come, with ownership still being held as before. This has already been demonstrated in the case of WNS and E-Funds. Going forward we should see different kinds of strategic partnerships and alliances being formed. Joshi of Zenta feels that we will witness business cycles similar to those seen in the ITS business.

Although suppliers will become increasingly savvy, the market is still not mature for build operate and transfer arrangements and clients who have little experience of international business will find it hard to make the captive option work for them. It is likely that some captive centres and traditional outsourcers will enter the third party services market, WNS (spun off from British Airways) and E-Funds are examples of this. As these players expand, it is conceivable that these BPO captive centres will be spun off as independent mega-suppliers.

<b>Third party service providers: Pros and cons</b>	
<p><b>Advantages</b></p> <ul style="list-style-type: none"> <li>• Focus on core business issues.</li> <li>• Benefit from best-of-breed solutions.</li> <li>• Better quality at lower costs.</li> <li>• Better process maturity, resource flexibility and economies of scale.</li> <li>• Flexibility in deploying new technology.</li> <li>• Quick wins with outsourcing.</li> </ul>	<p><b>Disadvantages</b></p> <ul style="list-style-type: none"> <li>• Burden of excess capacity or challenge of insufficient capacity is done away with.</li> <li>• High unit personnel cost.</li> <li>• Tight business margins.</li> <li>• Not enough financial muscle to sustain very tight payback periods.</li> </ul>

## Captive units: Pros and cons

### Advantages

- Securing data is less complicated.
- Capture margins that would otherwise go a TPSP.
- Decision making authority contained within the organisation.
- Tighter management control.

### Disadvantages

- Expensive specialist skill in host countries.
- Compliance and legal restrictions.
- Unavailability of skilled manpower due to market stagnation.
- Requires considerable effort in terms of management's time and attention to establish

## Savings by outsourcing work to—

### Third Party Service Providers (TPSPs)

- Usually TPSP already has expertise and experience with other clients in similar business lines.
- Very competitive pricing / flexibility to assess various TPSPs
- No infrastructural / capital investment.
- Payback period very less (usually between 6 months to a year).
- Flexibility to source multiple TPSPs.
- Flexibility to scale up and down business relationship.
- Can exit from one relationship and move to another .
- Retains decision-making, therefore relationship with TPSP is clear (fee-based, quality-based); no staff backlash.
- As TPSP works towards a profit there is more business commitment.
- Customised solutions ensure data security and safety.

### Captive centres

- Build expertise from scratch by redeploying resources. Latter option more expensive.
- Unit costs higher.
- High capital investment.
- Payback usually between 3 and 5 years.
- Committed to bringing in economies of scale, hence the need to establish a sufficiently large centre.
- Committed resources reduces such flexibility, else training costs could shoot through the roof.
- No exit possible without incurring high costs.
- May or may not retain decision-making. Possibility of backlash from senior management personnel.
- Captive units are usually cost centres.
- Long-term strategy looks for establishing centres to first move work as-is, and save costs first.