Managing The Changing ROI Of Offshore Outsourcing

By Marcia Robinson, president, and Ravi Kalakota, CEO, of E-Business Strategies

General Electric recently divested a 60% stake in General Electric Capital International Services (GECIS), its global business-process-outsourcing operation, to two venture-capital companies, General Atlantic Partners and Oak Hill Capital Partners, for $500 million.

Why did GE auction off part of its profitable back-office captive center? Was India beginning to lose its economic allure? Did GE's management anticipate that the country's rising costs and management attrition would make offshore outsourcing less of a competitive advantage in the future?

The actions of GE illustrate an interesting point: The changing market dynamics in various offshore markets require a rapid adjustment in ROI and value-management techniques. Without such an adjustment, companies that have recently begun offshore-outsourcing initiatives will realize a less-than-expected return from their investments.

The ROI of offshore outsourcing evolves constantly, causing headaches for managers attempting to justify initiatives. Accelerating offshore business complexity has rendered conventional "snapshot" ROI estimations obsolete. Increasingly, companies have to manage and monitor their offshore ROI due to several reasons:

- Salary-sensitive ROI
- Location-sensitive ROI
- Project-oriented vs. process-oriented ROI

Salary-Sensitive ROI

Cost, quality, and productivity are the three reasons companies commonly cite for offshore outsourcing. Of these, cost savings ranks first. Despite platitudes about quality or productivity, cost is the variable that has the most impact on the decision to go and stay offshore.

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Employee salaries tend to be the largest and most prominent cost component of an offshore project. Any change in employee salaries due to competitive increases or attrition tends to ripple throughout the ROI models. To quantify this issue, Table 1 lists the salary ranges in India for entry-level graduates and middle management.

Degree	First-Tier City	Second-Tier City
Bachelor of Science (No experience)	$5,000–$8,000	$3,750–$6,000
Bachelor of Science (Two to three years of experience)	$8,000–$13,000	$6,000–$9,750
Master of Science or Master of Business Administration (No experience)	$15,000–$18,000	$11,250–$13,500
Master of Science or Master of Business Administration (Eight to 10 years of experience)	$30,000–$40,000	$22,500–$30,000

Table 1: The Cost of IT Employees in First-Tier and Second-Tier Cities in India Data: E-Business Strategies

Table 1 also illustrates the difference in salaries paid to employees located in India's first-tier cities (Bangalore, Mumbai, Hyderabad, Delhi, Pune, Kolkata, and Chennai) and second-tier cities (Jaipur, Ahmedabad, Kochi, Chandigarh, and Visakhapatnam). It's important to note that within a category, top performers expect to be paid double the salaries of average performers, and good managers are extremely hard to find and expect to be compensated accordingly.

How much have salaries increased since companies like SAP, IBM, Hewlett-Packard, and Accenture began sending work offshore? One 2004 study conducted by the human-resources and outsourcing firm Hewitt found that Indian professionals working in software development enjoyed average salary increases of almost 13.7%, while those employed by the IT-enabled services industry (call centers, back-office operations, and medical-transcription companies) saw their compensation rise by 13.8%.

The same study projects that salaries on average will jump again in India by between 9.7% and 13.4% in 2004. In Bangalore, the Silicon Valley of India, the increases have tended to be much higher, given the frenzied pace of hiring by new entrants. If you couple these statistics with U.S. Bureau of

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Labor Statistics data that found the wages and salaries of workers within U.S. private industry rose by a comparatively low 2.5% between the fourth quarter of 2002 and the fourth quarter of 2003, it's not hard to see why the onshore-offshore wage gap is closing slowly but surely.

Constantly rising salaries place great pressure on managers in the midst of offshore projects. If they match the market rates, then they have to do so for everyone across the board, an action that reduces their overall ROI. Not matching market rates means risking the loss of top performers in the middle of projects, which also can have a devastating impact on the success and ROI of the offshore project. Managers face a true conundrum that defies attempts to put a tight lid on expenses.

Location-Sensitive ROI

Low-cost country-location strategies that once seemed like a sure bet with respect to offshore value creation seem less certain with each passing day. The limits of wage arbitrage and rising overhead have undoubtedly raised the stakes for companies that plan to begin, renew, or expand offshore-outsourcing projects. Let's examine some issues that are affecting location economics.

Location always matters. Companies that pick vendors or destinations before evaluating the inflation and attrition rates of the offshore location don't have much room to maneuver once projects are under way and costs escalate. Businesses that set up their own back-office units offshore should be particularly careful when they select their location, as the costs incurred from an internal, failed captive-center operation are apt to be much greater.

Location matters even more when you factor in tax law changes. Recently, changes in India's tax law have generated uncertainty among the multinationals that have their own captive subsidiaries in India. The tax-law changes are seen as beneficial to the local outsourcing firms. In light of the new tax circular, GE's decision to sell off its Indian captive center represents a timely move to monetize an asset, and one that other U.S. firms may imitate given the multiples on outsourcing operations.

Government actions affect ROI in unpredictable ways. For example, consider India and China. Both countries are experiencing rising consumer prices, wages, and attrition rates as their economies expand; however, there is some good news for those businesses offshoring work to China. While both countries can assert some measure of control over their economies by managing currency rates, India is a free market and China is not. Ultimately, this means that the Chinese government has more power to control rapidly increasing consumer prices and wages. The same can't be said for India.

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To hedge against location issues, companies are moving from captive-center models to pure outsourcing. Several recent deals point to this trend. Chicago-based Aon Corp. sold its claims-processing unit to Singapore-based Scandent Group, and Tata Consultancy Services purchased units of Singapore Airlines and The Phoenix Companies, a U.S. asset-management firm.

Process-Oriented Vs. Project-Oriented ROI

In addition to location, the nature of offshore work—process vs. project—has interesting implications for ROI management. Anything in the area of BPO with a steady, continuous workflow is considered process-oriented. Project-oriented work, on the other hand, is time-based with clear start-and-stop windows.

The benefits from process-oriented offshoring work such as call centers are usually more difficult to quantify and measure than those of project-oriented work such as IT application development and maintenance, which are well defined. Despite the challenges of value measurement, more and more companies are tackling process-oriented offshoring initiatives.

In general, process-oriented initiatives fall into two categories: productivity-driven or cost-driven. The ROI from productivity-driven projects tends to be fuzzy (for example, a faster response to customer E-mail complaints will build loyalty in customers and result in greater customer satisfaction). The ROI from cost-driven projects, however, is determined with a “show me the clear savings” calculation (for example, replacing 100 highly paid employees with lower-cost resources).

Process-oriented ROI is highly sensitive to external factors such as knowledge transfer, knowledge codification, and attrition. For instance, it can take call-center representatives or mortgage-processing clerks months to build up knowledge capital about their client’s products or services and customers. When they suddenly leave to accept a higher-paying position elsewhere, that knowledge capital is lost, and the training and learning processes must begin anew.

Companies often think they can operate process-centric operations like call centers on a plug-and-play model (simply plug the worker into the call-center role and immediately provide quality customer service). They are mistaken. Absent an infusion of skilled, experienced labor, long-term productivity suffers, resulting in a lower ROI. Process-oriented ROI is very sensitive to the stability and size of the operation. The greater the number of workers united in a highly standardized, stable setting, the higher the likelihood of generating ROI.

Managing ROI—A Dynamic Process

Spending a quarter to get a dime? If you are not vigilant about proactively managing the changing dynamics of the offshore markets, this could be

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your situation. What are some things you can do to avoid being caught in an ROI downdraft?

Monitor The Critical ROI Impact Variables: Every initiative starts with good intentions and an execution plan to deliver what top management believes the company needs. Too often the benefits everyone expects—lower costs, increased operational efficiencies, or better quality—are cast aside when the nitty-gritty execution work begins.

During the project, most companies don't question their initial assumptions to determine whether the ROI can realistically be achieved. They fail to identify when and how to measure an offshore project's progress. With no way to gauge whether the ROI from the offshore project is on track, they wait until the end to decide whether their efforts have paid off. By then, it's too late to adjust. Millions of dollars have been wasted because managers haven't adequately identified, planned for, or measured the key variables.

There is a better way. It requires monitoring the critical variables that affect the ROI at each stage of an offshore project's life cycle, so managers can adjust strategies based on interim results. For instance, if you find it difficult to recruit and retain middle management in an offshore captive center, scaling back the initial project would be a prudent step. This structured approach to monitoring a project's ROI ensures that the expected ROI calculations in the business case actually materialize.

Sense And Respond: Strategies that worked yesterday may not work today. Companies have to adopt a sense-and-respond approach when they execute offshore projects to make sure that they are on track. For example, if they find that the programming talent they require for their project has dried up, they should consider sourcing the work to different vendors rather than sole sourcing.

Best-practice companies build efficient supply networks to complement their captive operations. A supply network is a community of offshore suppliers that share knowledge and resources with the company, so they can adjust to changing market conditions. GE, American Express, and Citigroup all practice this approach.

Another solution might be to move to another city or country. An example of this strategy is what is often termed I2I (India to India). Companies attempt to proactively manage labor and infrastructure costs by relocating from a first-tier city in India such as Mumbai, which has some of the highest real estate costs in the world, to a second-tier city such as Chandigarh (Dell is opening its third call center there).

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Sense-and-respond adaptation is a natural condition in all aspects of life. Survival often depends on the ability to adapt. In the offshore arena, adaptation is no longer optional; it is mandatory. Rising labor costs, attrition, competition, and regulations require businesses to possess the flexibility to continually change and adapt.

Define ROI Monitoring Responsibility: Many companies never question initial offshore assumptions, let alone adjust them. Instead, they focus on tracking milestones associated with the execution of the project, often only budget—and schedule—performance measures. This is very different from understanding the project's intended impact on the business.

ROI ownership is a key aspect of tracking a project's benefits. It means assigning someone accountable for the ROI. Too often, executives have only limited ownership of project ROI, and the responsibility for seeing that the ROI is realized falls solely on the project team. Team members, however, are extremely busy with day-to-day execution, so this approach usually does not work. A better way is to assign ROI monitoring to someone who has accountability for both interim and final deliverables that support the achievement of overall objectives.

The Bottom Line

How do you continue to extract increasing value from your captive offshore initiatives? What is your company doing to guide its offshoring-outsourcing projects to success despite rising costs?

The ROI that companies receive from offshore projects is changing every few months. A change in the underlying assumptions or expected ROI means that even well-crafted strategies have to be adjusted. The best long-term strategy conceived by the brightest consultant holds little value if it's based on what worked last year. The year 2005 promises to be an interesting one.

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