Strategic Challenges Facing Captive Centres

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Synopsis

Firms such as General Electric, Texas Instruments and Motorola that established captive centres[1] in India in the mid-1990s had formerly kept most of their offshored tasks in-house. Since then, however, the Indian IT service sector has grown and developed abilities to carry out both simple and complex IT maintenance and development, often more cheaply than their western competitors. This development has made western multinationals consider how to better utilize their offshore assets. For example, in 2006 SAP Hosting Services in Bangalore outsourced several hosting services to Tata Consultancy Services (TCS), also based in Bangalore. Other companies, such as Standard Chartered and Hewlett Packard (HP), have followed a different approach in which their captive centres have provided services to both parent company and external service providers. British Airways, on the other hand, sold a majority stake of its captive centre to the private equity firm Warburg Pincus in 2002. Apple Inc went even further and closed down its development centre in India in 2006. Clearly, such changes suggest that the basic concept of the captive centre is being transformed

The Offshoring Industry

While offshoring has been around for a long time, in particular since US multinationals offshored labour-intensive manufacturing to low-cost developing countries such as Mexico and Panama, a significant development within the concept of offshoring has taken place since the mid-1990s. Companies such as Citigroup and American Express have started setting up offshore facilities to carry out enterprise-wide activities. As Friedman described in his book, *The World is Flat*, a global, web-enabled playing field has been created since the 1990s which has changed the way work is carried out and services are delivered (Friedman, 2005). Since then, software maintenance and development has been carried out in a dispersed manner and at lower costs in countries such as Israel, India, the Philippines and China.

The Drivers of Offshoring

Cost savings is the main factor that drives offshoring. For example, a programmer in the U.S. earns around $100,000 yearly, while a programmer in India with the same qualifications and skills earns $30,000 or less. One study found that American companies save $0.58 on every dollar spent on jobs moved to India (Farrell, 2005). The main savings come from wages and from the bundling of activities in one location which results in a large economies of scale.

The shortage of qualified labour in the West also prompts more companies to adopt Business Process Outsourcing (BPO) and Information Technology Outsourcing (ITO). The technology boom in the 1990s and the Y2K effect at the turn of the millennium boosted programmer wages in Western countries. Companies therefore started to search for alternative solutions in India, China and Eastern Europe.

[1] A captive centre is a wholly-owned-subsidiary located offshore that performs various tasks ranging from the development of software applications to providing customer support for the parent company. (Oshri et al. 2008)

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Offshoring work is not exempt from challenges and risks. Therefore, firms have traditionally considered three options in this context: (i) to contract work out to a service provider located offshore, (ii) to set up a joint venture with an offshore company, or (iii) to set up a wholly-owned captive centre to carry out work at an offshore location.

Offshore Outsourcing

Offshore outsourcing is defined as a contracting activity with a third service provider that is located offshore for the completion of a certain amount of work, for a specified length of time, cost and level of service.

Offshore outsourcing was first adopted by healthcare, telecommunication and technology industries in the late 1980s. Back then, industries in the US and other Western countries suffered from labour shortages. The demand for cheap, low-level data-entry personnel who were proficient in English led to offshore outsourcing in India and the Philippines. During the technology boom of the mid-1990s, offshore outsourcing was driven by the need to gain access to talented developers.

When choosing an offshore service provider, cost, quality, security and proximity are the main considerations. While such factors for successful offshore outsourcing have been known for some time, there have been quite a few examples in which offshore outsourcing projects have failed.

Joint Ventures with Offshore Service Providers

Joint ventures between a parent company and an offshore service provider have taken place since the 1980s. The main purpose of the joint venture is to reduce the risk of offshore outsourcing by gaining more control over intellectual properties, quality and costs. Companies that had no presence or limited developed infrastructure in a remote region often prefer to form a partnership through a joint venture with a local vendor over the establishment of a captive centre or contracting out work to an offshore vendor. For example, an insurance firm or a retail bank would buy a company based offshore and run it jointly with the previous owner for a while in order to learn and understand local market conditions and gradually shape work routines according to their philosophy. When ready, the new owner would complete the takeover and assume full responsibility of the venture.

There are still significant risks in setting up a joint venture with an offshore service provider. Though the parent company may gain control over processes and critical knowledge, and could share know-how with its local partner, there could still be intellectual property breaches and mistrust between the partners.

Captive Centres

While companies have steadily increased the volume of work outsourced to offshore service providers, many have also set up offshore captive centres, the number of which is steadily growing.

Most captive centres are set up for one of the following reasons: to acquire skilled and motivated personnel or to expand and enter new markets[2]. Reducing costs, though perceived

[2] The following reading provides more information about these aspects: E. Carmel and P. Tjia, “Offshoring Information Technology” (Cambridge University Press, Cambridge, UK, 2005)

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to be one of the rationales, is in fact not so (see Table 1 in Appendix A). The cost-base of a captive centre in India, for example, is about 15% more than the cost-base of a local service provider. Some of the benefits associated with setting up a captive centre include the ability to secure intellectual properties and the more limited exposure of core competencies (Subramanian and Atri, 2006).

Captive centres, however, have been struggling with ever-increasing costs, high employee attrition levels and the lack of integration with the firm's global strategy, and at times a lack of headquarters support. The size of a captive centre is an imperative factor that could affect its success rate. Small captive centres are often hard to maintain, as these cannot build up large-scale operations and also can offer little long-term career growth to their employees, often resulting in a high level of attrition.

The Emergence of Captive Centres

Captive centres arose in the mid-1990s. General Electric Capital International Services was one of the first companies to open a captive centre in India in 1997. From the year 2000, the number of captive centres in India increased significantly. Among the Forbes 2000 companies, 44 had captive centres in India in 2000, 71 in 2003 and 110 in 2006, with about $9 billion worth of IT and BPO activities shifted to captive centres in India in 2006 alone. By the end of 2008, over 500 captive centres had been set up in India (Offshoring Times, 2008). The captive centre market is now expected to grow by 30% yearly (Mishra, 2007). Among the most active sectors in setting up captive centres are the banking and finance, computer and electronics sectors.

Setting up a captive centre, however, involves more than simply hiring employees, renting a building, and installing hardware. It requires both the development of unique capabilities and some specific expertise. A captive centre is also affected by institutional forces such as political and regulatory changes, taxation, foreign investment regulations and the development of local labour markets. In addition, local employees' proficiency in English, the size of the local workforce and the educational system in the region are other factors that a multinational should consider when making such a decision.

Though a well-functioning captive centre can offer some advantages, including massive savings in comparison to onshore activities, about 50 per cent of all captive centres have failed (Offshoring Times, 2008). Most captive centres face difficulties in the areas of product engineering, Research and Development (R&D), IT and other BPO services. Over 60% of captive centres suffer high operating costs and face around 20 per cent staff turnover. Some commentators have recently predicted that the captive centre model will eventually disappear, whereas others believe that it will remain as a viable alternative to offshore outsourcing.

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Trends in Captive Centres

Attractive Locations

Multinationals have set up captive centres in various countries and regions, including India, China, Latin America, and Central and Eastern Europe. India has proven to be the favourite location because of its vast human capital, sophisticated level of education and relatively low language barrier.

Labour costs offshore are still expected to be lower than in Western countries for another 20 years, though the difference is narrowing. Declining labour-cost advantages are offset by the increased availability of qualified personnel and improved business environments.

Key emerging markets in Southeast Asia, Latin America and Eastern Europe are becoming more interesting in terms of talent, industry experience, quality certification and regulatory environment.

Southeast Asian countries are strengthening their position as an alternative offshore location to India and China. Indonesia, Malaysia, the Philippines, Singapore, Vietnam and Thailand are among the most attractive 20 offshore locations worldwide, according to A.T. Kearney's Global Services Index[3].

New policies that promote service exports to Latin American countries such as Argentina, Brazil, Chile, Mexico, and Uruguay have enhanced the attractiveness of these countries.

Newcomers in Eastern Europe, such as Bulgaria, Slovakia, and the Baltic States, are outperforming more established locations in the region such as the Czech Republic, Hungary and Poland.

The Middle East and Africa are on the rise, with Egypt, Jordan, Ghana, South Africa, Israel, United Arabic Emirates, Tunisia, and Turkey being the leaders.

These alternative locations to India have invested in roads, airports, telecommunications and other key infrastructures to attract ITO and BPO deals. Offshoring to these countries, however, will not soon catch up with India, which will probably hold its position for the next decade or more (Joshi and Mudigonda, 2008). Indeed the intent is to supplement, not replace India. Interestingly enough, the number of captive centres newly established in Eastern Europe and Russia rose significantly between 2004 and 2007 to the extent that together its growth rate has surpassed India's. However, India still has the highest number of captive centres by far.

[3] The consultancy firm A.T. Kearney publishes the Global Services Index every year, rating the 50 most attractive offshoring destinations. Countries are evaluated against 43 measurements across three major categories: financial attractiveness, labour and skill availability, and business environment.

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Two Tales of Captive Centres

GlobalSoftware

GlobalSoftware, a leading software developer, planned to set up a product development centre in India in the late 1990s. According to the co-director of the captive centre, "India has excellent people and it provides many opportunities to grow fast" (Singapore Press Holidings Limited, 1999). When the captive centre was established, the Internet boom was at its peak and IT companies were in need of talent and skills. Alain, the director of Process Improvement and Performance Management, recalls: "There was an arbitrage of costs and to certain extent some pressure to recruit the people".

In 1998 GlobalSoftware acquired IndiaTesting, a company that provided front-office software for marketing and business operations. The acquired company already had a team of 70 experienced software professionals, who immediately started to work on the parent company's new "Sales Force Automation" project and were directly involved in testing and customization. Within a few years, the captive centre was able to expand its activities. Testing was among the most important services because of its cost advantage and effectiveness. For cost reasons, the captive centre also hired many young people coming straight out of colleges in India. They were three to four times cheaper than engineers from the home country, claimed the captive centre manager of Business Research Extension. In 2002, the captive centre employed 500 software developers and received investments of over $125 million from its parent company. By 2006, it had increased the capacity to over 3,000 staff, many of them software developers.

Despite all the success, both the captive centre and the parent company had their worries. Top managers from the captive centre felt that the full potential of the captive centre had not materialized. In particular, managers thought that the software giant still considered its captive centre as a back-office that should perform low-level tasks cheaply. One aspect of this was that all product development decisions regarding products that were partly or fully developed by the captive centre were still taken by the parent firm headquarters. This approach did not allow the captive centre to make recommendations about the firm's product portfolio and about the development of product features within the existing product line.

From the parent company's perspective, the captive centre's high staff attrition rate was a serious problem. This problem was not unique to GlobalSoftware—many Western companies in India as well as local IT vendors faced the same challenge. "If we have a high level of attrition," said Alain, "we do not get to build domain knowledge. And if we do not build domain knowledge, we do not get more responsibility from the parent firm, GlobalSoftware. If you have an attrition of 25%, every two years you virtually start from zero".

Addressing the High Attrition Challenge

In order to cope with the high attrition levels, the captive centre sought to outsource some of the repetitive tasks performed in-house. These were some of the hosting services that provided technical support to both internal and external clients. The captive centre also perceived the outsourcing of these services as an opportunity to divert talent from low-value to high-value activities. To accomplish this, the company entered a due diligence process with a service provider that was based nearby and which had had long term relationships with the parent firm. The outsourcing project was of small scale, about 2 million USD per year, and involved the transfer of knowledge and hosting services from the captive centre to the

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vendor over a period of three months, after which the vendor would assume full responsibility over these services. In order to successfully accomplish this outsourcing project, the captive centre and the vendor agreed on the governing structure, business processes and knowledge transfer mechanisms and procedures, and the timelines per each major milestone. As the vendor was one of the leading Indian vendors in this area of services, Alain felt that he was in good hands. After all, the vendor had undertaken so many similar contracts that providing the captive centre with such services should not be a major challenge. Furthermore, there was also the perception that since the client and vendor were located nearby, any issue which might arise would be easy to handle over a face-to-face meeting. Having discussed these matters, GlobalSoftware and the vendor were ready to launch this outsourcing project.

By early 2006, not long after their collaboration had commenced, Alain was not satisfied with the vendor's performance. Things got even worse later that year. Alain complained: "We are so busy managing the vendor that at times it feels that we could have kept this activity in-house and would be better off. They never catch up with our introduction of new services. We trained their staff and yet we see that knowledge is not retained within their teams. We assumed that their employees, who are Indians, have the same perception as we have regarding quality and service standards. We were wrong!"

The project manager from the vendor's side, who was also frustrated with the situation, gave a different picture: "True, we suffer from a high level of attrition that affected our ability to retain knowledge. However, the client does not help with their continuous introduction of new services. They want far more than what we can deliver for such a small project. Yes, we have excellent methodologies to capture and retain knowledge and we also have service standards. But how can we justify applying these methodologies, procedures and techniques when it comes to such a small project?"

Alain was rethinking recent developments within the GlobalSoftware captive centre. Although the outsourcing project was not going so well, he developed a good personal relationships with the vendor's relationship manager. He was hoping that the relationships with the vendor could be improved and that soon the performance would also get better. But what should they do? He was hoping to free up resources who could focus on high value activities and instead his workforce was now tied up in vendor management activities. Furthermore, he was wondering whether this outsourcing contract is changing the original purpose of setting up the captive centre? If so, how did this strategy fit into GlobalSoftware's overall strategy?

GlobalAirline

In 1996, Nicolas, the now former managing director of GlobalAirline, one of the biggest European airlines, received a warning alarm: if the company wanted to survive, it had to get in shape soon. Profits had declined and the cost-base of passenger processing activities had been rising. Nicolas put together a task-force that included the general manager of the engineering department. His task was to analyse cost savings. He noticed that passenger revenue accounting demanded high-volume, low-skilled work that could be moved to a cheaper offshore location. The passenger revenue accounting unit then had over 600 full-time staff. Though GlobalAirline was familiar with offshore outsourcing, it had not outsourced passenger revenue accounting because it "was the blood of the organization" and had to be kept under control, according to Nicolas.

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In August 1996, GlobalAirline decided to establish a wholly-owned captive centre in India, to bring down costs while keeping control. The captive centre was to be run as an independent profit centre. India was chosen because the airline had direct flights from the headquarters location. GlobalAirline saw India's infrastructure as developed, which allowed for a relatively easy data transfer process. Culture was not perceived as a problem: the company was already familiar with the local markets and many of the cultural aspects in India. Indian workers were fluent in English and in addition the Indian government provided significant tax breaks among many other benefits.

The captive centre was set up under an airline subdivision responsible for providing services and systems to external clients. A general manager who had experience of customer services, sales and marketing in foreign countries was sent to India to set up the captive centre. Shortly after its establishment, the captive centre started to offer additional services such as customer relations. "Again, this was a high-volume activity, requiring a very quick turn-around," said Nicolas. "The prime reason for moving customer relations to the captive centre was that it was becoming very expensive as a department to run—it needed many extra staff'.

As a wholly-owned subsidiary, the captive centre was not named after GlobalAirline. Its staff were employees of the captive centre, not of GlobalAirline, to prevent union problems. A wholly-owned subsidiary also had the flexibility to reach third party clients. Nicolas said: "It became easier for me to make deals. If the captive centre had had the parent company's name, there would have been major restrictions".

The captive centre started off with 60 employees in a commercial space that could accommodate 300 people. But it grew quickly. Nicolas remembered: "I had a number of companies coming to ask me what we were up to and wanted to know more about our services. Following this, GlobalAirline's top management quickly agreed that the captive centre should offer services to third parties because it could bring down costs". However, "there was a lot of scepticism among the middle managers back home about whether the Indian captive centre would work", said Nicolas.

This scepticism was unjustified. The captive centre successfully acquired third party clients within a short period of time, thanks to GlobalAirline's worldwide alliance programmes. When the captive centre was launched, the parent company had already formed an alliance with other airlines, which included a trading services programme. One key aspect to any success was information security. Being a wholly-owned subsidiary that did not carry the parent company's name helped the captive centre to be less exposed to security breach attacks and made competitors less suspicious about confidentiality aspects when negotiating deals with the captive centre.

Consequently, in November 1996, the captive centre was already serving three external clients and was best known for supplying specialist computer skills such as ticketing and computer-based training. In 1998, the captive centre broke even as expected and started to offer services to other businesses outside the airline industry, such as insurance. Nicolas said: "Again, the opportunity came partially through the parent company because one of the management directors was also on the executive board of an insurance company". By 2000, the captive centre was offering services to nine other airlines and had revenues of $25 million a year.

Following the expansion of the GlobalAirline captive centre and its range of services to third party clients, the captive centre management team sought ways to further develop the unit. At

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that point in time, the captive centre employed 1,500 staff, of whom 65 per cent were serving the parent company and 35 per cent were providing services to third party clients. In fact, the 35 per cent focusing on external clients generated 45 per cent of the captive centre's total $11 million revenue.

Dave, the former captive centre General Manager, remembered that when he forwarded the five-year additional expansion plan to the management director of GlobalAirline, the director snapped: "What have you smoked? You have put forward a plan for 12,000 staff, which is about 30% extra headcounts for GlobalAirline". The board of the parent company stressed that they were running an airline, not an investment house, and therefore rejected the plan. However, as an external commentator observed: "The future strategy of the captive centre requires investments to fully exploit its growing third party client base" (Dow Jones International News, 2001). Capital was needed to develop skills relating to marketing and sales and building the scale of transactions within the captive centre. A clash arose between the parent company and its captive centre regarding the centre's strategic direction. "It became obvious that the only way for the captive centre to advance was to be sold off," Dave commented.

In 2001, GlobalAirline considered a takeover of its captive centre by an investment house. The basis for the negotiations was that any agreement should 'allow the future growth and development of the captive centre, with the airline company still retaining a significant stake in the business" (Reuters News, 2001). The negotiations took over 18 months. According to representatives from the captive centre side, the airline did not want management overheads in India and was concerned with service quality and costs once the private equity firm assumed a majority stake of ownership. Losing key employees was another concern. The private equity firm wished to see the new captive centre managed without the parent company's influence. It was prepared, therefore, to sack old employees and let its people run operations.

Finally, in 2002, a deal was struck. GlobalAirline announced the sale of 70 per cent of its captive centre equity stake (Financial Times, 2002). GlobalAirline did not intend to be involved in management decisions relating to the captive centre, now that its major stake was held by the private equity firm. However, it hoped to still improve the financial performance from this transaction when the eventual value of its 30 per cent stake in the captive centre would increase.

GlobalAirline chose the private equity firm for two reasons. "Money-wise they came with a good offer", Dave remarked, "and they had the right structure and culture to protect the interest of the airline, the captive centre's principal customer". The takeover would also let the airline concentrate on its core business and let the captive centre develop new businesses outside the airline industry.

The private equity firm was interested in acquiring GlobalAirline's captive centre because the captive had established a leading position in the BPO segment in India. "The basis of the captive centre, its infrastructure, set-up, and management team, was very attractive", Dave added. GlobalAirline's positive reputation, strengthened by its ISO 9000 certification and Six Sigma model, also helped the private equity firm make this acquisition decision. According to the private equity firm, during the divesture the BPO sector worldwide was poised to witness tremendous growth, and the firm saw the buyout as a valuable investment in building a leading global organization. The CEO of the private equity firm confirmed: "With this

captive centre, we now have deep domain knowledge of the sector. We will let the new company grow organically as well as through acquisitions in the Indian BPO market". The new chairman of the captive centre also thought that the captive centre had a great potential to handle complex and varied business processes, as there was no other captive centre in India with such large scale and advanced domain knowledge.

After the acquisition, the private equity firm allotted a considerable sum of money to further develop the services provided by the captive centre. The intention was that the captive centre staff would increase to 10,000 full time employees in the next 5 years. "We can grow organically at 50% a year to the foreseeable future", predicted the new captive centre chairman.

Within its first year as an independent company the captive centre revenue grew by 120%, and by 2005 the BPO firm reported USD165 million in revenues. Supported by this rapid growth, the captive centre went public in July 2006. It then faced new challenges. The Indian government applied different regulations to public BPOs and captive centres. Tax breaks for captive centres shrunk and in June 2006 the captive centre was asked to repay service taxes to the government for the period 2003-05. Meantime, however, the captive centre had to satisfy its shareholders, who wanted a higher return on their investment each year.

Despite the difficulties, the IPO still allowed both GlobalAirline and the private equity a return on their investments. In 2008, according to Dave, only 10-12% of the USD460 millions in revenues were being generated by the former parent company. The captive centre was able to increase its capacity to over 18,000 employees, who were considered as core staff and no longer as back-office workers. This attracted more talent to the captive centre and supported the knowledge-base developed offshore.

According to Dave, fast growth was possible because the private equity firm spent a great deal of money to "rebuild the communication infrastructure and bring in some very senior management plus their contacts and networks". Fast growth, however, did not come easily. Dave added: "The captive centre had to fight for contracts after larger multinational players like IBM had entered India—there are few contracts left in the market not taken by the big companies".

Accounting for 40 per cent, travel was still the strongest segment of the captive centre's mainstream revenue. Banking, financial services, and insurance, however, together generated 40 per cent of the revenue. The emerging segments of manufacturing, retail and consumer products supplied the remaining 20 per cent of the revenue. According to the director of Investments and Alliances at GlobalAirline, "the venture has turned out more successful than most of the airline leadership expected. There was no question that the airline made the right decision. The company has benefited from both its initial stake in what later became a successful commercial venture and also from the fact that its business processes are being done by a more efficient and viable entity". But one might wonder: have GlobalAirline done the right thing? Perhaps they should have maintained ownership of the captive centre, considering its success?

Epilogue

The basic concept of a captive centre is to provide services to the parent company from an offshore location. However, the above stories illustrate a different reality. Some captive centres have outsourced part of their activities to a local vendor, while others have expanded

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by providing services to external clients. Divesting the captive centre is another move that some parent companies have considered, and in other cases the captive centre has been closed down.

These strategic moves bring to the fore the following questions. How should a parent company strategically perceive its captive centre in terms of its allocation and utilization of resources? And in doing so, what capabilities should be developed offshore to support the evolution of a captive centre?

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Appendix A

Table 1: Setting up costs: Local Provider versus Captive Centre

Criteria	Local providers	Captive
Annual salary	$7,770 to $ 8,200	$9,500 to $10,300
Shifts per day	1.2 to 1.5	1 to 1.2
Costs per square foot (Bangalore)	$11 to $13	$14 to 16
Expatriates for every 1,000 full-time employees (FTEs)	0 to 1	3 to 5
General management staff for every 1,000 FTEs	12 to 14	16 to 18
General management annual salary range	$55,000 to $65,000	$70,000 to $90,000
Travel and entertainment costs per FTE	$280 to $320	$900 to $1,060

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