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The outsourcing and offshoring industry is at a turning point. What began as a small-scale sector dedicated to application development, accounting, and payroll has become, as of 2008, an $80 billion global industry, addressing a range of business processes and technology services. As the IT services and BPO industry matures, however, challenges are emerging.

Our research finds that more than 70 percent of offshore delivery centers, including both wholly owned captive operations as well as vendors, narrow their global operations to just three locations, often situated in only two countries (most frequently India, China or the Philippines). This reliance on a limited number of geographic regions—historically driven by the availability of highly skilled, low-cost labor in these areas—is exposing providers to a variety of location-specific risks. These include abrupt currency and wage fluctuations, intense competition for employees, and regulatory limits. While a narrow geographic concentration may result in lower labor costs at the outset, the overall risks are higher, according to our research. The same is true on a microlevel: our data show that when a delivery center in a large Indian city grows beyond 3,000 employees, costs spiral and performance begins to deteriorate.

Offshore service providers can mitigate these risks in the way a financial manager would—by diversifying their holdings. While diversification has long been the rule for investment decisions, outsourcing providers were under little pressure to change their lowest-cost-country approach until recently, when rising volatility in many favored offshoring markets began to impair providers’ ability to predict costs and manage talent needs. As a result, many are looking to address these vulnerabilities while still reaping a cost advantage.

Offshore delivery centers can accomplish this goal by diversifying their operations in two ways: on a macrolevel, by expanding their global footprints.
to reduce overconcentration in any one region; and on a microlevel, by broadening the range and scale of activities conducted in any one center. The result is a network approach to offshore delivery management that features centralized global delivery hubs and decentralized local or specialized service spokes. This next-generation model not only improves overall global delivery but also brings greater predictability to cost management while fostering better coordination, flexibility, and responsiveness—characteristics that can give global companies a sharper edge in this period of rapid change. The remainder of the article and exhibits that follow illustrate the benefits inherent in moving to this new model.

**The benefits of a portfolio approach**

The underlying volatility of today’s markets makes planning more difficult, particularly in the cost-sensitive IT and BPO service industry model. With increasing pressure on margins, service centers need to anticipate changes in costs—and avoid

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**Exhibit 1**

**Why diversify**

One Paris-based company offshored high-end IT services across several locations, seeking to minimize exposure to geographic, currency, and labor issues.

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**A location portfolio buffers the effects of structural volatility . . .**

Potential IT services center locations, number of employees, and IT specialist annual wage¹

<table>
<thead>
<tr>
<th>Country</th>
<th>Employees</th>
<th>Wage (USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>100</td>
<td>$40,000</td>
</tr>
<tr>
<td>Romania</td>
<td>300</td>
<td>$25,000</td>
</tr>
<tr>
<td>Egypt</td>
<td>300</td>
<td>$20,000</td>
</tr>
<tr>
<td>India</td>
<td>1,300</td>
<td>$20,000</td>
</tr>
<tr>
<td>Bangalore</td>
<td>500</td>
<td>$25,500</td>
</tr>
</tbody>
</table>

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. . . which decreases overall risks while still enabling significant cost savings

Risk and wage development for IT services center, single location vs portfolio

<table>
<thead>
<tr>
<th>Wage development¹</th>
<th>Level of risk for portfolio²</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Paris (home base)</strong></td>
<td>Offshore location only in Bangalore</td>
</tr>
<tr>
<td></td>
<td>Decreased talent risk</td>
</tr>
<tr>
<td></td>
<td>Less currency volatility</td>
</tr>
<tr>
<td></td>
<td>Improved business environment</td>
</tr>
<tr>
<td></td>
<td>Portfolio of offshore locations (Bangalore, Cairo, Iaşi, Lille)</td>
</tr>
<tr>
<td><strong>Offshore in Bangalore only</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Portfolio</strong></td>
<td></td>
</tr>
</tbody>
</table>

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¹Based on weighted average wage, 2008.
²Uses weighted average risk values for portfolio, plus additional synergistic effects of currency volatility and talent risk.
sharp movements in local market conditions (such as higher wages, labor shortages, and inflation). Such swings have been particularly marked in preferred offshoring destinations such as India, where the economics of doing business were significantly altered in the space of the 15 months between January 2008 and March 2009. Over that period, the rate of wage inflation fell by eight percentage points (to 4 percent), the US dollar rose 32 percent against the rupee, and employee turnover declined by 15 percent. These double-digit swings would have wreaked havoc on any cost projections and have made planning quite tricky.

Delivery centers can ease the planning burden by adding other geographies to their portfolios—ones that offer more stable economic profiles or whose market movements counteract those of the original location. Doing so allows companies to hedge their exposure to risk and makes managing costs more predictable. Such considerations form the basis of strong portfolio planning.

The following composite example illustrates how one company, based in Paris, used this strategy to its advantage (Exhibit 1). The company was looking to offshore 2,000 specialized, high-end IT jobs and initially planned on sourcing the entire project in India. It opted for an alternative scenario, however, after running the numbers as part of its due diligence. With a view to minimizing its exposure to geographic, currency, and labor

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Exhibit 2

Considering the options

Nontraditional offshoring locations offer trade-offs between cost and risk.

Risk rating for business process offshoring (on a scale of 1 to 5, where 1 = “attractive” and 5 = “unattractive”)

1.0 2.0 3.0 4.0 4.5

Fully loaded cost per FTE, \$ per year

1Composite assessment of investment risk, security environment, threat of disruptive events, regulatory risks, data security, quality of infrastructure, and extent of government support.
2Southeast Asia represents average values for Indonesia, Philippines, Thailand, and Vietnam.
3FTE = full-time equivalent; fully loaded cost includes wages plus costs such as telecom, infrastructure, and overhead.
issues, the company tiered the work across several locations, placing roughly two-thirds of the project in India and splitting the remaining third across three other regions. It kept 100 jobs in Lille, France, and nearshored 300 more in low-cost Romania, because of the proximity of these locations to European markets. A further 300 were placed in Egypt, where government programs have substantially broadened the talent base. The company then housed the remaining 1,300 roles in Bangalore. By diversifying in this way, the company significantly lowered its overall portfolio risk while incurring only marginally higher costs than it would have under the all-India approach.

**A qualitative and quantitative advantage**

In popular offshoring locations, processing centers are often pitted against one another in the war for talent—a battle that often results in higher wage and recruitment costs for delivery centers. A diversified location portfolio acts as a buffer against talent shortages while expanding access to a broader range of business, technical, functional and domain skills, languages, and other competencies. India, for instance, remains a top offshoring destination because of its reputation for low-cost, high-quality talent. Yet markets such as Egypt, South America, and Southeast Asia have been on the map for some time as viable offshoring locations. For scale-oriented delivery services, their comparable cost and risk structures make them attractive alternatives to heavily penetrated countries like India (Exhibit 2). By tapping into non-traditional destinations, companies may succeed in achieving a comparative cost advantage versus the competition. Qualitative factors—such as time zone, the suitability of the local skill base, the region’s proximity to key customers, and the existence of government initiatives—also play an important role. Although Eastern European countries are more expensive, for example, they bring strong specialist talent, the requisite language skills, and excellent infrastructures; these factors may often compensate for the higher cost.

**Diversifying on a microlevel**

Government initiatives have enhanced the service options available for companies looking to choose an offshoring location (see sidebar, “An enhanced menu of location choices”). Some emerging markets, such as India and Malaysia, are becoming attractive R&D locales as a result...
of a concentration of elite universities and public–
private research parks. These locations offer
specialized pockets of talent and subject matter
expertise. Despite these opportunities, many com-
panies tend to focus on “transaction only” centers—
those that cater to basic needs such as data entry,
simple payroll processing, and account documen-
tation. This narrow scope can cause a center’s
overall performance to deteriorate over time, since
competitors often converge in similar markets
and draw down the available talent pool.

As a result, it becomes important for companies to
diversify on the microlevel as well. By expanding
the range of work conducted in centers to include
higher-level skills, such as market research and
analytics, delivery centers can limit their exposure
in any one competency and provide more attrac-
tive career choices—improving employee retention
and lowering costs. Our data indicate that those
outsourcers and offshorers that leverage different
types of talent within an integrated service model
(often called a center of excellence) can achieve
cost savings of 12 to 22 percent over those of their
transaction-processing-focused peers (Exhibit 3).

The limits of scale
A center’s performance generally improves with
scale, but there are limits. Our research into more
than 80 offshore service centers in India shows
there is a tipping point, after which disecono-
 mies emerge based on the size of the available talent
pool and the need to fill more seats with increas-
ingly scarce and therefore more expensive talent.

We found that when centers in Hyderabad and
Bangalore grew to around 2,000 to 3,500 seats, for
instance, their cost performance began to de-
teriorate. To counter this, companies should assess
their own performance profiles and scout new
locations before their existing centers grow too
large. As Exhibit 4 shows, having multiple
locations versus one or two megacenters not only
maintains the right cost–performance balance,
but also helps to foster network effects.

A next-generation strategy for offshore
operators
When a provider has only three outsourcing centers,
it is easy to consider them as separate entities.
Yet the use of multiple sourcing locations can create
valuable network benefits in the form of improved
governance, process standardization, workflow
transitions, and contingency planning. When coor-
dinated well, the whole can be greater than the
sum of its parts.

One service provider, facing too narrow a concen-
tration of geographies, skill sets, and centers,
sought to create a next-generation global delivery

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Exhibit 3

<table>
<thead>
<tr>
<th>Service Center</th>
<th>Nonintegrated</th>
<th>Integrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Data entry</td>
<td>7.96</td>
<td>6.24</td>
</tr>
<tr>
<td>Transaction processing</td>
<td>9.19</td>
<td>8.09</td>
</tr>
</tbody>
</table>

1 Full-time equivalent.
Rethinking the model for offshoring services

Before the change, it operated a cluster of centers in India and China. These free-standing units managed everything from HR to service delivery at the center level. The result was unnecessary duplication of activity and poor coordination between locations. In addition, a few centers were highly skilled in some applications, but because competing projects stretched existing resources and slowed development time, the provider was unable to leverage and channel the right skills for the appropriate tasks. To address these issues, the provider moved to a global network approach with global operations hubs delivering finance and accounting, HR, and customer service in four locations in Asia, Eastern Europe, North America, and South America. These facilities managed global back-office functions on a centralized basis, eliminating redundancy and improving knowledge sharing across the network.

At the same time, the company decentralized its software-development labs, creating a network of competence centers around the world, each specializing in a specific product line or software capability. These centers integrated a mix of high-level skills—including product R&D and system programming, along with more basic tasks—in order to boost productivity and volume.

This new structure yielded several benefits. Consolidating core operating functions eased the oversight burden, allowing management to focus its attention on high-level issues, while enabling individual centers to cooperate on day-to-day matters more directly. This new approach allowed the company to standardize processes, establish common frameworks, enforce best practices, improve delivery speed, and streamline process handovers for round-the-clock global coverage in

Exhibit 4

The tipping point

Companies must search for new locations and set up new centers proactively, before the performance of existing centers deteriorates.

![Comparative costs for offshoring service centers at scale](image)

- **Cost:** $ per work hour
- **Center size:** number of seats

1 Logarithmic scale.
Glance: One provider sought to create a next-generation global delivery model by allocating work dynamically.

The global operations hubs. Meanwhile, the decentralized spokes (the company’s network of specialized development labs) focused on developing specialist skills to enhance innovation speed and superior project delivery for high-end IT projects. These changes combined to lower costs and improve performance.

Global service delivery for business and technology services is gradually coming of age. The operating model of service delivery centers has traditionally benefited from low labor costs at outsourcing sites concentrated in China, India, and the Philippines. But with the wider economy poised for what will likely be a sustained period of underlying market volatility, financial and structural risks are rising. As the industry matures, so too must its service model. To sustain future growth, providers need to create a network of offshore centers to diversify their risk and provide greater management flexibility.

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