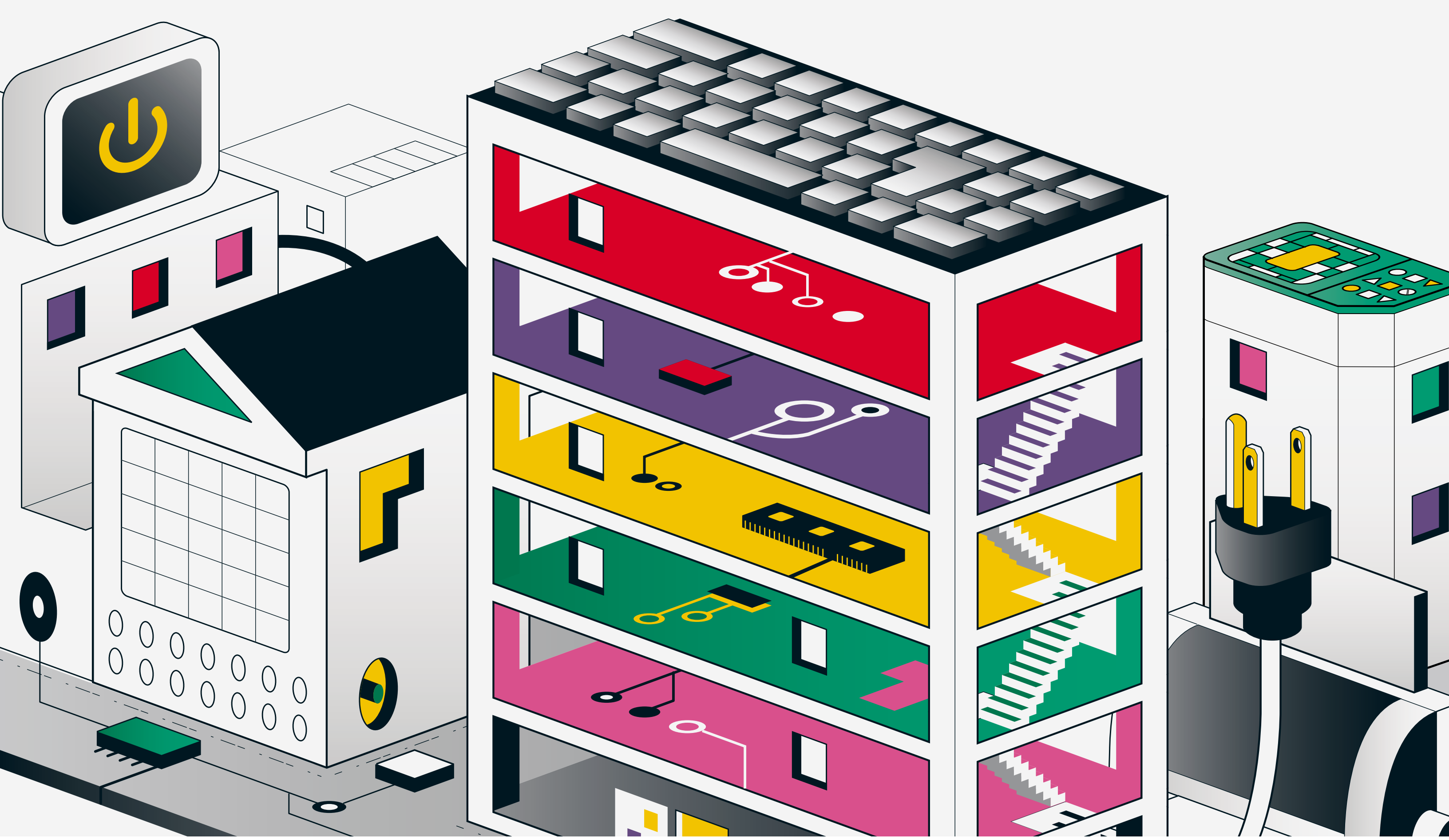
McKinsey&Company

McKinsey on Business Technology

Number 16, Summer 2009



Rethinking the model for offshoring services

BPO providers often rely on a limited number of geographic locations, exposing themselves to unnecessary risk. They can mitigate these risks in the same way that financial managers do—by diversifying their holdings.

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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 that 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

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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

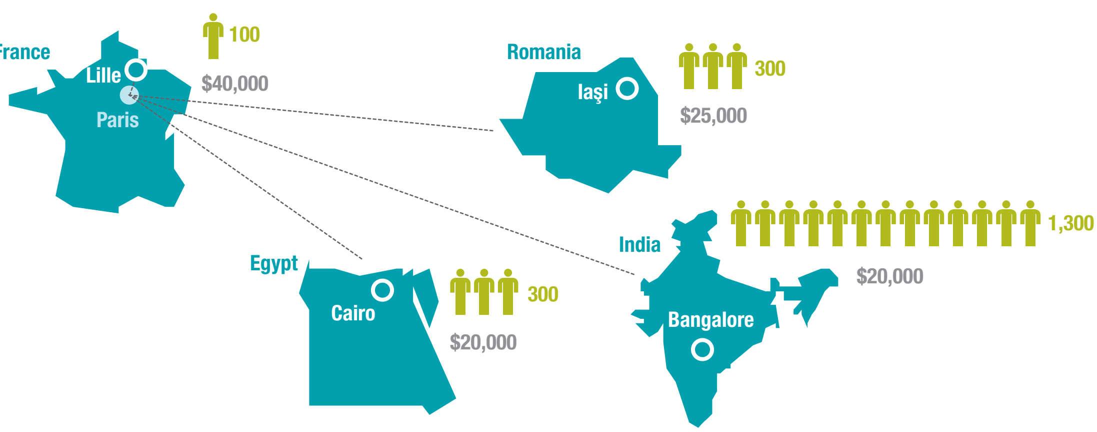
Exhibit 1

Why diversify

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

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

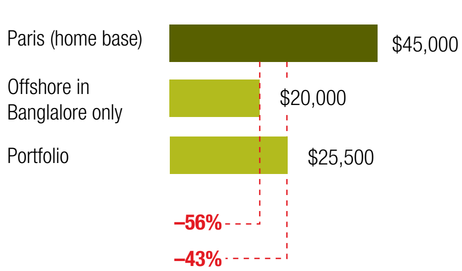
Potential IT services center locations, number of employees, and IT specialist annual wage[1]



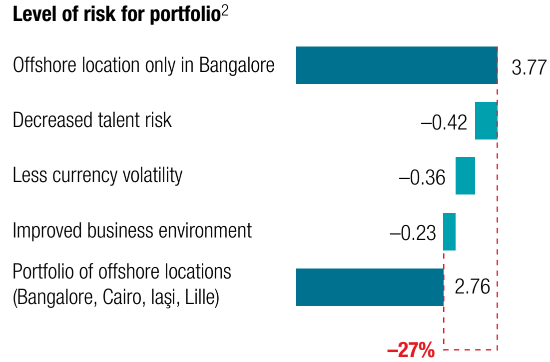
. . . which decreases overall risks while still enabling significant cost savings

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

Wage development[1]



Level of risk for portfolio[2]



[1]Based on weighted average wage, 2008.
[2]Uses 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.

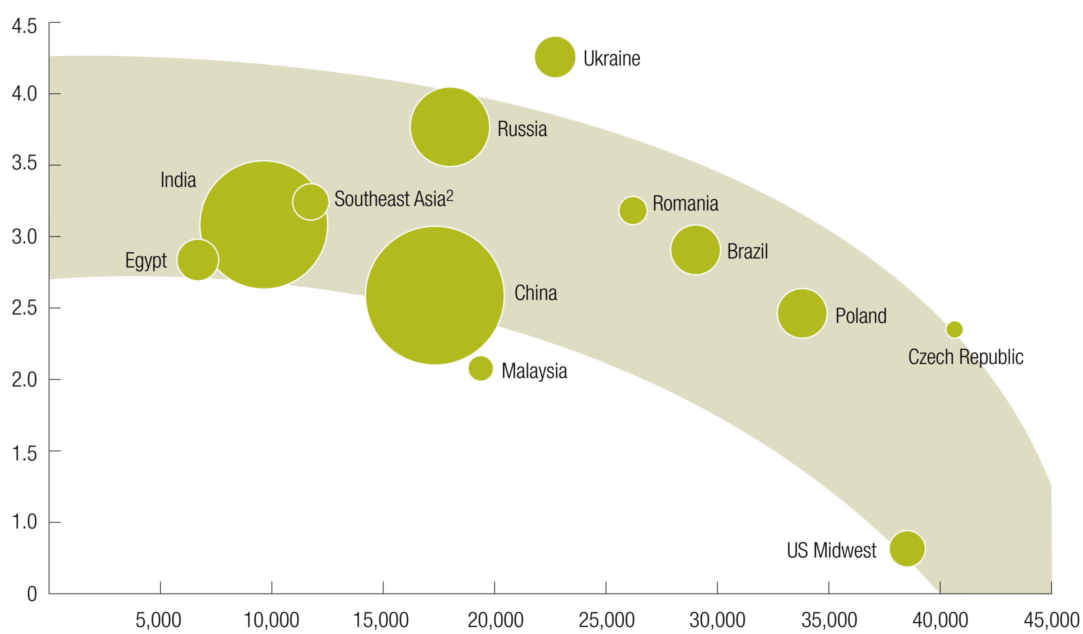
The following composite example illustrates how one company, based in Paris, used this strategy to its advantage (Exhibit 1). The company was looking to offshore 2,000 specialized, high-end IT jobs and initially planned on sourcing the entire project in India. It opted for an alternative scenario, however,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

Exhibit 2

Considering the options

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

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



Fully loaded cost per FTE,[3] $ per year

[1]Composite assessment of investment risk, security environment, threat of disruptive events, regulatory risks, data security, quality of infrastructure, and extent of government support.
[2]Southeast Asia represents average values for Indonesia, Philippines, Thailand, and Vietnam.
[3]FTE = full-time equivalent; fully loaded cost includes wages plus costs such as telecom, infrastructure, and overhead.

An enhanced menu of location choices

North America

- The midwestern United States can provide high-quality services, reflecting shared language and culture
- Offers access to large market, proximity to customer base, and presence in United States

Eastern Europe

- Strong specialist and multi-lingual talent base, excellent infrastructure
- Multitiered markets within close proximity to one another, offering high-, medium-, and low-level skill sets

China, India

- Large, multiskilled talent pool
- High concentration of research universities
- Potential for scale centers
- IT services are special focus area for Chinese government

South America

- Argentina and Brazil have different risk profile and infrastructure specialties; European languages
- Potential for same-time-zone support for local subsidiaries

North Africa

- Low-cost countries, such as Morocco and Egypt, feature government support, improved technical skills
- Offer potential source for balancing other, more saturated, scale locations

Southeast Asia

- Philippines features strong English-speaking talent pool; potential for voice services
- Malaysian government active in cultivating strong research base
- Vietnam and Indonesia continue to be attractive low-cost locations

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.

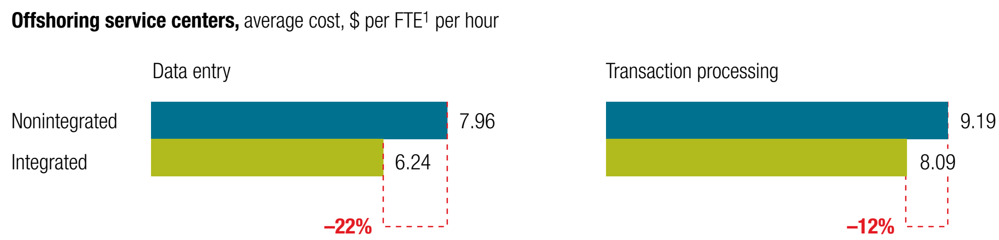
Diversifying on a microlevel

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

Exhibit 3

An integrated service model

Companies that leverage the full breadth of the talent pool improve the performance of their offshoring centers.



[1]Full-time equivalent.

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 companies tend to focus on "transaction only" centers—those that cater to basic needs such as data entry, simple payroll processing, and account documentation. 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 attractive 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 diseconomies emerge based on the size of the available talent pool and the need to fill more seats with increasingly 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 deteriorate. 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 coordinated well, the whole can be greater than the sum of its parts.

One service provider, facing too narrow a concentration of geographies, skill sets, and centers, sought to create a next-generation global delivery model (Exhibit 5). 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.

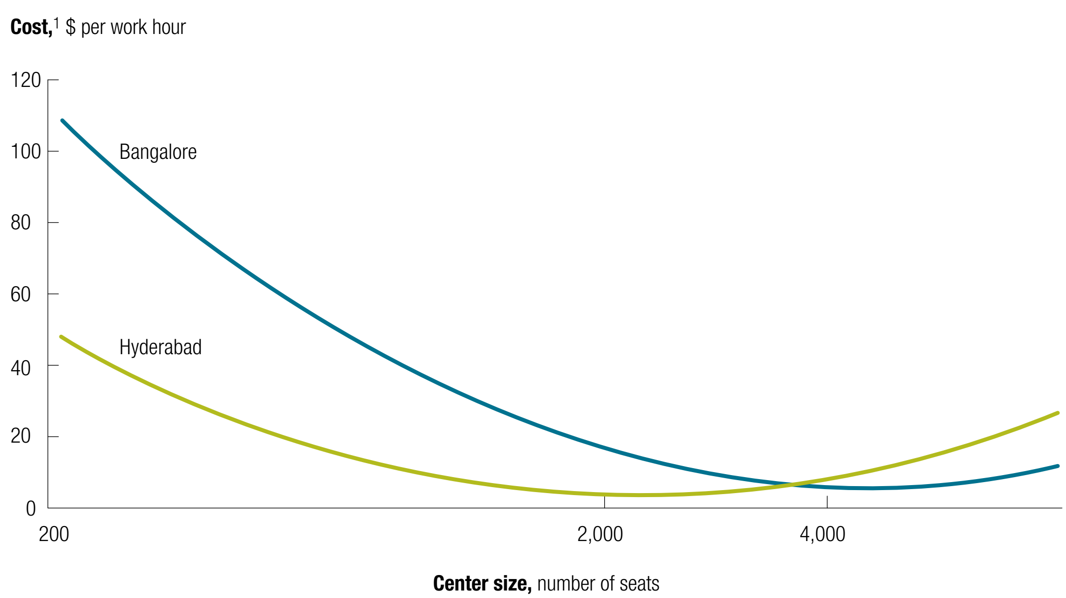
This new structure yielded several benefits. Consolidating core operating functions eased the oversight burden, allowing management to focus its attention on high-level issues, while enabling individual centers to cooperate on day-to-day matters more directly. This new approach allowed the company to 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



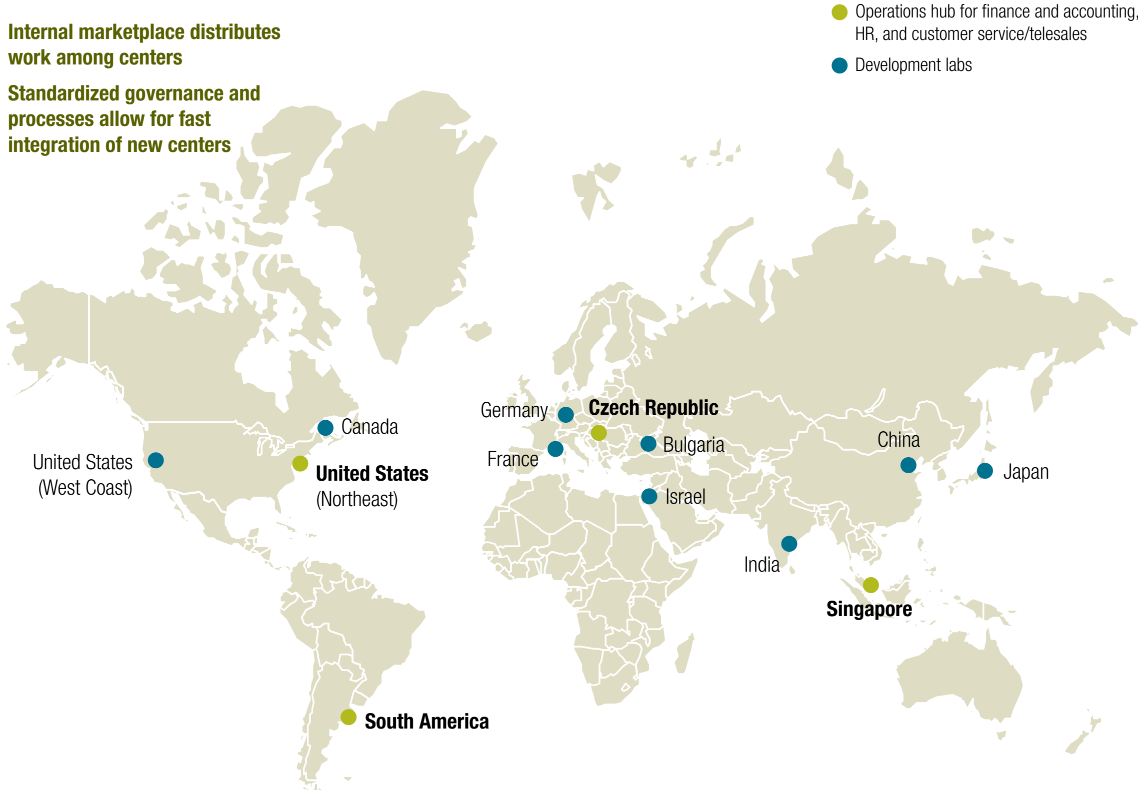
[1]Logarithmic scale.

Exhibit 5

International distribution

One provider sought to create a next-generation global delivery model by allocating work dynamically.

International distribution of development and back-office work, disguised example of software and services company



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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