Global Sourcing
Market Update: October 2007

Topic: Comparison of Outsourced and Captive Solutions for Capturing Value from Offshoring

Preview Deck

ERI-2007-2-PD-0204

Background and objectives of this research

Background

- As companies determine how to best utilize offshore capabilities, they must inevitably determine the extent to which they will build their own "captive" operations (offshore center operated by the company) or contract with a third-party supplier of services
- This is a multi-faceted decision for which a range of factors must be assessed to determine which approach provides the greatest value. Although both approaches utilize lower-cost labor to provide lower costs, some other sources of value that can be attained are dependent upon which model is utilized

Key objectives

- Provide a brief overview of the types of value a company may attain from offshoring efforts
- Provide a rigorous framework and analysis to compare captive and third party models on Total Cost of Ownership (TCO), highlighting that the cost differences go beyond "economies of scale" and "focus"
- Provide insight into the drivers of cost differences between captives and third-parties

This research will be most useful to executives looking for the following:

- A holistic perspective on the types of value offshoring can provide – cost, business, and strategic
- An evaluation of sourcing models in terms of near term cost savings and long term value creation
- A comparative assessment of key cost drivers for captives vis-à-vis third parties

Scope of the research

The scope of analysis includes the following:

- A description of the types of value offshoring can provide
  - One-time reduction in TCO
  - Other types of value – Ongoing cost reductions in TCO, Business impact, Strategic impact

- A detailed analysis of the TCO for third-party and captive offshore solutions
  - This includes base costs, transition costs, third-party SG&A[1] costs, and third-party margins
  - Additionally, the analysis assesses the differences for transaction-based and expertise-based processes
  - The TCO analysis assumes that the offshored services are:
    - Back-office processes delivered from Bangalore, India
    - Provided by a sophisticated captive or third-party that has invested in process improvement capabilities and attained a meaningful scale
    - Pursued by a buyer that has a mature, long-term perspective of offshoring and has invested substantially in building appropriate capabilities required to manage the relationship

- A high-level analysis of other types of value delivered by third-party and captive offshore solutions - includes analysis of the various levers/investments that drive higher value and the scenarios under which the captive or third-party model can better capture value

- The TCO analysis was conducted using a proprietary cost structure model developed by the Everest Research Institute. This model uses parameterized inputs to enable accurate comparisons across different situations (e.g., delivery models, management structures). The inputs used for this analysis are based upon information from the Everest Research Institute's work with captives and third-parties, plus additional interviews to confirm and refine the inputs. The values used reflect the range of operating parameters observed in typical delivery situations.

1 Sales, General, and Administrative

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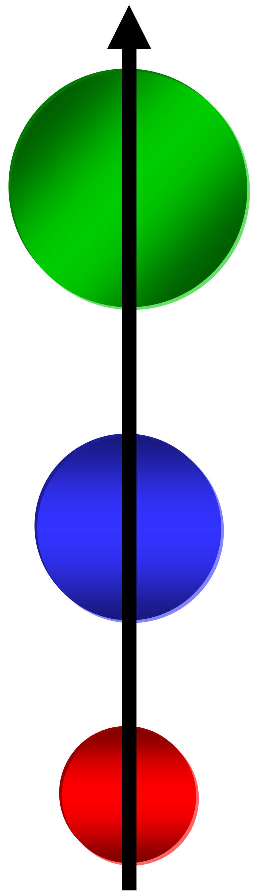
Offshoring can be utilized to attain numerous types of value beyond just cost savings

Three levels of value creation

Examples of potential types of value that are commonly pursued via offshoring



Strategic impact

- Access to new markets, e.g.,
  - Support entry into new geographies
  - Improved understanding of new cultures to lead adaptation and development of products and services
- Access to new pools of talent, e.g.,
  - Enlarge pool of scarce technical skills
  - Increase pipeline of management talent
- Scalability and flexibility of business model

Business impact

- Reengineered processes
  - Increased efficiency/automation
  - Greater use of standards
- Support variations in demand

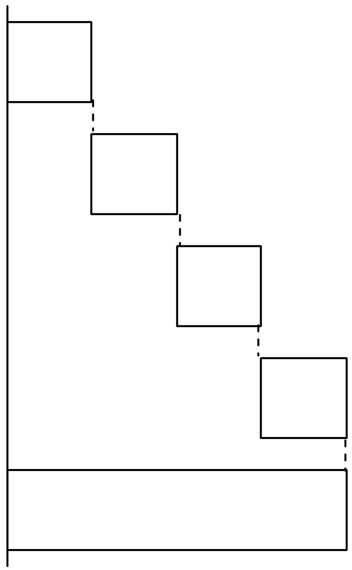
Cost impact

- Ongoing reductions in TCO
- One-time reduction in TCO

Source: Everest Research Institute (2007)

Total Cost of Ownership is an important factor to consider in choosing between a captive or third-party offshore operating model

- Common to captive and third-party
- Unique to third-party



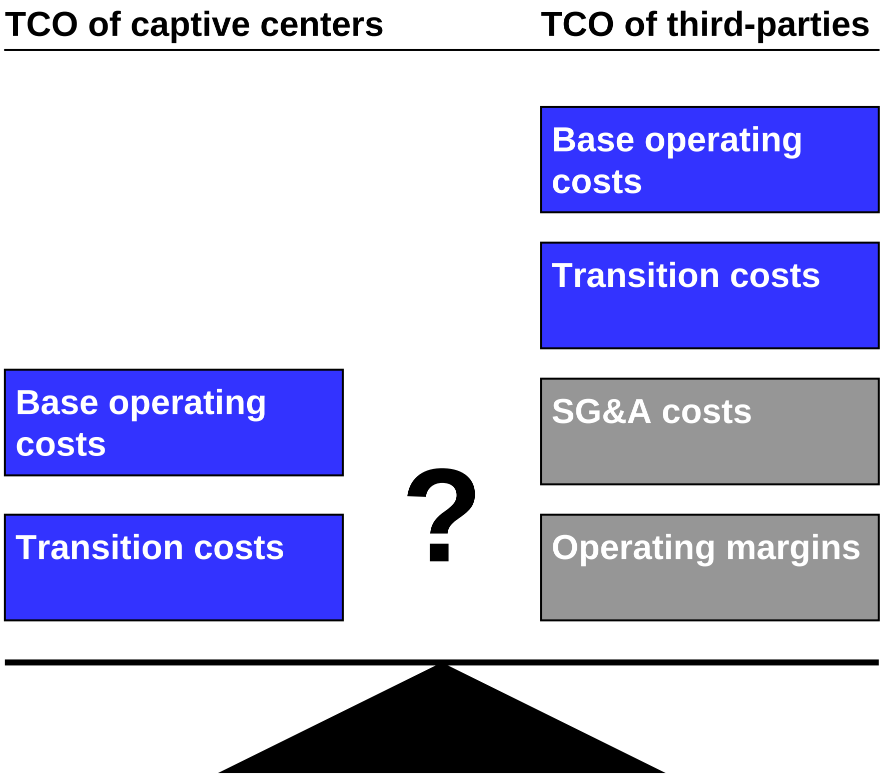
TCO components	Definition
Base operating costs	Ongoing costs of operating a representative offshore delivery center of a certain size once steady-state has been achieved
Transition costs	Annualized one-time costs involved in shutting down onshore operations and bringing the offshore operations to steady-state
SG&A costs	Appropriate allocation of costs involved in acquiring clients and managing corporate office administration
Operating margins	Margins of the third-party over and above the costs incurred to support delivery and acquire customers
TCO	Total cost to the buyer of offshore services

- TCO reflects an annualized value of all costs incurred in owning and operating an offshore delivery center
  - Direct costs (labor, facilities, telecommunications, etc.)
  - Indirect costs (management overheads, asset replacement, etc.)
  - Hidden costs (attrition, downtime, etc.)
  - One-time costs (facility search, knowledge transfer, ramp-up, etc.)
- In addition, TCO also reflects incremental costs that buyers will incur in a third-party model (SG&A costs and margins)
- However, TCO is not a complete reflection of all the value created through offshoring (business benefits, strategic value, etc.)
  - For example, TCO does not consider the value of business opportunities (market share increase through faster deployment, improved customer satisfaction etc) derived through a reduction in the application development lifecycle

Our TCO analysis focuses upon how third-parties create more leverage from operations to offset their SG&A costs and margins

Common to captive and third-party

Unique to third-party



Analysis focus and approach

- The TCO analysis was conducted using Everest Research Institute's proprietary cost model
- This model captures the financial impact of key levers affecting TCO (e.g., resource costs, management structures, attrition, travel and entertainment policy, transition time)
- The TCO analysis provide insight upon:
  - How and by how much do third-parties "pull" these levers advantageously relative to captives
  - The extent of cost advantage that they can reap, if any
- The insights of the TCO analysis have been validated with internal and external experts
- However, the outcomes do not apply universally to all captives and third-parties. The answer, in many cases, will depend on other parameters (scope of services offshored, scale of the captive, approach to process transformation, third-parties' ability to drive further labor arbitrage or scale, etc.)

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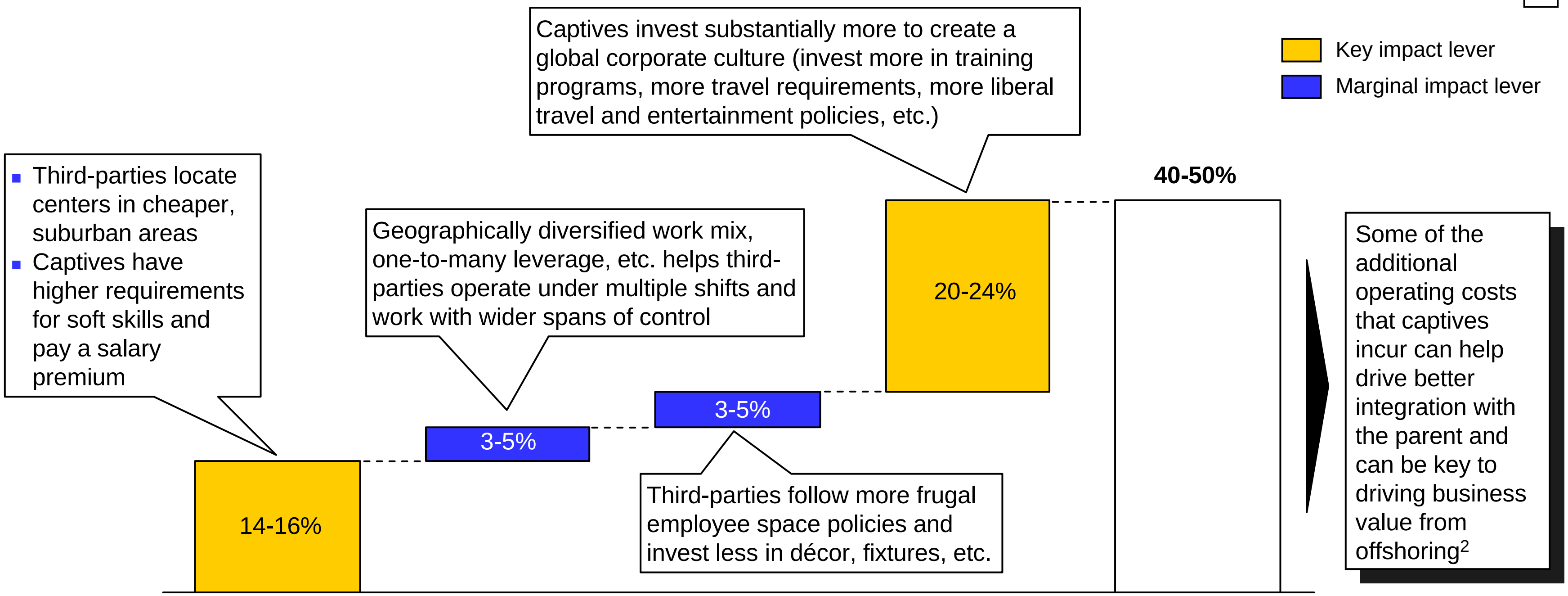
Third-parties create operating cost advantages through better leverage of scale, leaner operating environments, and tighter overhead management

Percentage of base operating cost difference explained by key levers[1]

TRANSACTION-BASED PROCESSES



Phases	Input cost	Resource utilization	Asset management	Overhead management	**Total**
Key components	Salaries, rent, bandwidth, training, etc.	Seat utilization, attrition rate, ramp-up time for new hires, etc.	Space allocation, investments in furniture and fixtures, etc.	Support/general/expat staff – pyramid, salaries, travel and entertainment costs, training costs, etc.	

1 Refer to page 54-57 of full report for a more detailed analysis of base operating cost differences
2 Refer to page 41-42 of full report for details
Source: Everest Research Institute analysis

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Illustrative analyses in this report (page 1 of 2)

SAMPLE

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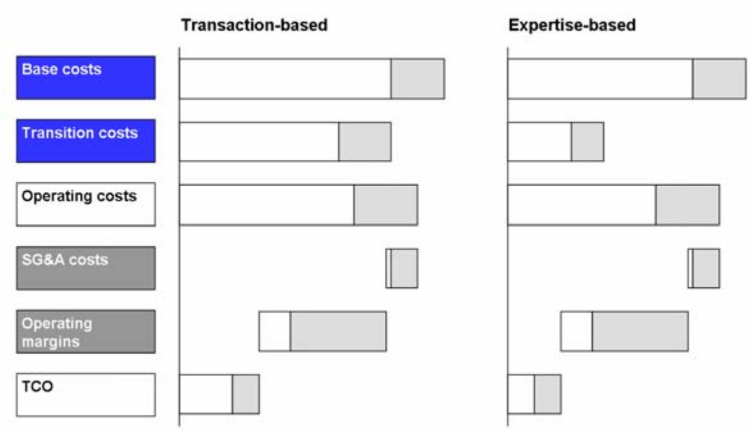
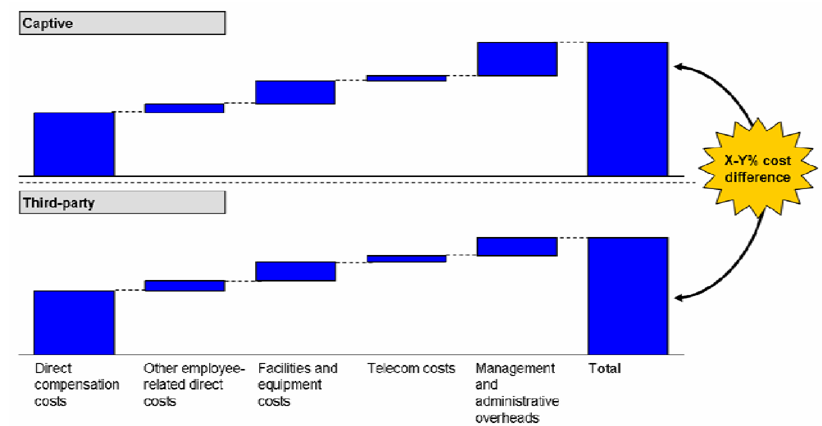
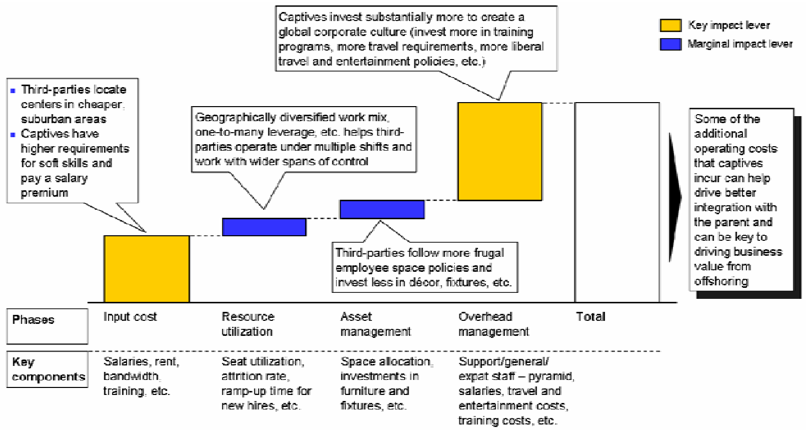
Comparison of third-party to captive TCO
Percent difference of captives over third-parties



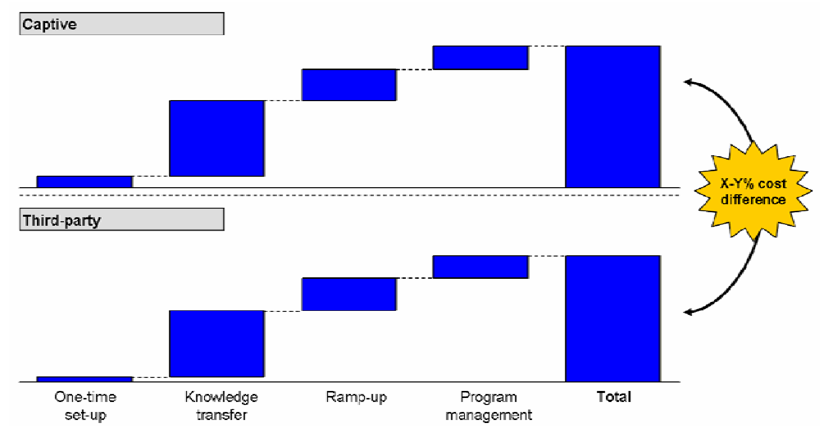
Comparison of third-party to captive base operating costs
US$/FTE/annum



Key levers of base operating cost difference
Percentage



Comparison of third-party to captive transition costs
US$/FTE



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SAMPLE

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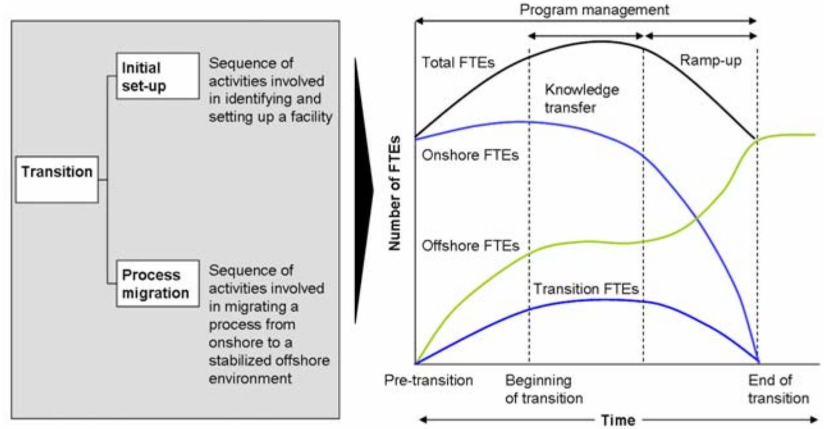
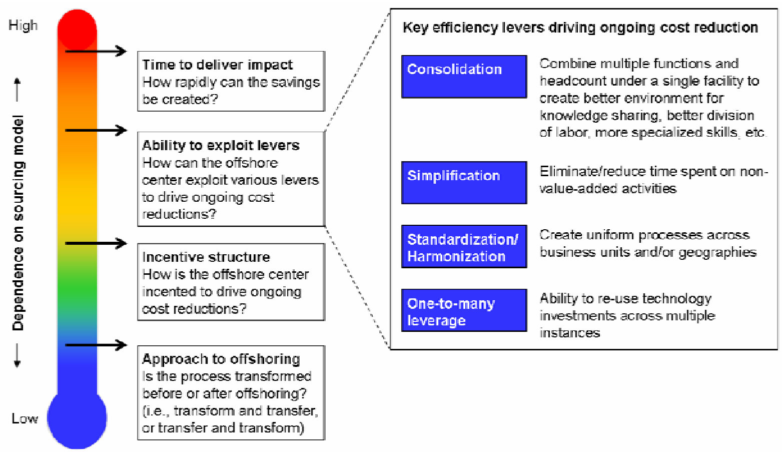
Sensitivity analysis for transaction based processes

Key drivers	Typical range for a third-party/captive	Sensitivity analysis – Impact of 10% change on base costs; US$/FTE	Typically levers influencing costs
Input costs			
Average salary of front-line staff	US$7,800-10,000 per FTE	800-1000	Ability to provide non-monetary incentives (such as promotion), target candidate profile
Rental cost	US$11-16 per sq. ft	70-130	Location of facility, total size
Transportation cost	US$950-1,100 per FTE	90-120	Transportation policy, location of facility
Cost of ongoing training	US$80-110 per FTE	8-12	Choice of trainers (external versus internal), Duration of training
Utilization			
Average shifts	1-1.5 per day	40-110	Geographic mix of work, nature of work (real-time vs. batch)
Span of control within front-line staff	1:8-1:9 (supervisor:agent)	40-70	Growth opportunities, best practices
Asset management			
Space allocation	80-140 sq. ft per employee	140-260	Space allocation guidelines, space management
Investment in furniture and fixtures	US$26-32 per sq. ft	40-100	Corporate policies
Overheads			
General management staff	12-18 per 1,000 FTEs	50-220	Corporate policies, extent of oversight required
Average salary of general management staff	US$55,000-90,000 per person	100-160	Benchmarking philosophy, salary/benefits structure, candidate profile
Travel and Entertainment costs	US$280-1,050 per FTE	30-110	Travel and Entertainment policy (accommodation, travel, per-diem, etc.)

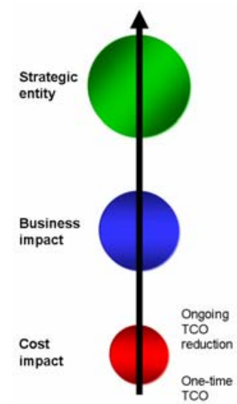
Key components of transition



Key factors driving ongoing cost reduction



Case examples of higher value-add delivered by captives



	Financial services conglomerate	Large hi-tech manufacturer
Strategic entity	Looking at commercialization possibilities Playing a leadership role in the firm's Global Reengineering division	Captive base leveraged for • Entry into domestic market • Providing leading-edge technology and hardware design for parent's local R&D center
Business impact	Established as a worldwide back-office processing Center of Excellence from data capture to financial reporting Parent entity established Global Re-engineering division to drive enterprise-wide transformation. Key talent in the shared-services organization leveraged for this division	Created global reengineering Center of Excellence on customer service
Cost impact – Ongoing TCO reduction	Re-engineered shared-service processes to drive productivity, quality and sustainable cost reduction	Increased productivity and standardization to become best-of-breed among all global centers
Cost impact – One-time TCO reduction	Assumed more complex, expertise-based processes such as cash applications, reporting, etc. Established credentials on cost savings for basic F&A transactional processes	Focused on establishing proof of concept for voice-based customer service, providing the same level of service quality while creating substantial cost savings

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Everest Research Institute has the resources, experience, and capabilities to provide companies with the strategic intelligence, analysis, and insight that are crucial to making the right decisions in today's outsourcing marketplace.

With the vision of our leadership team, the personal commitment, and indeed, the passion of our professionals to deliver real value to our clients, our organization is unsurpassed in its ability to guide your company's future success.

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