



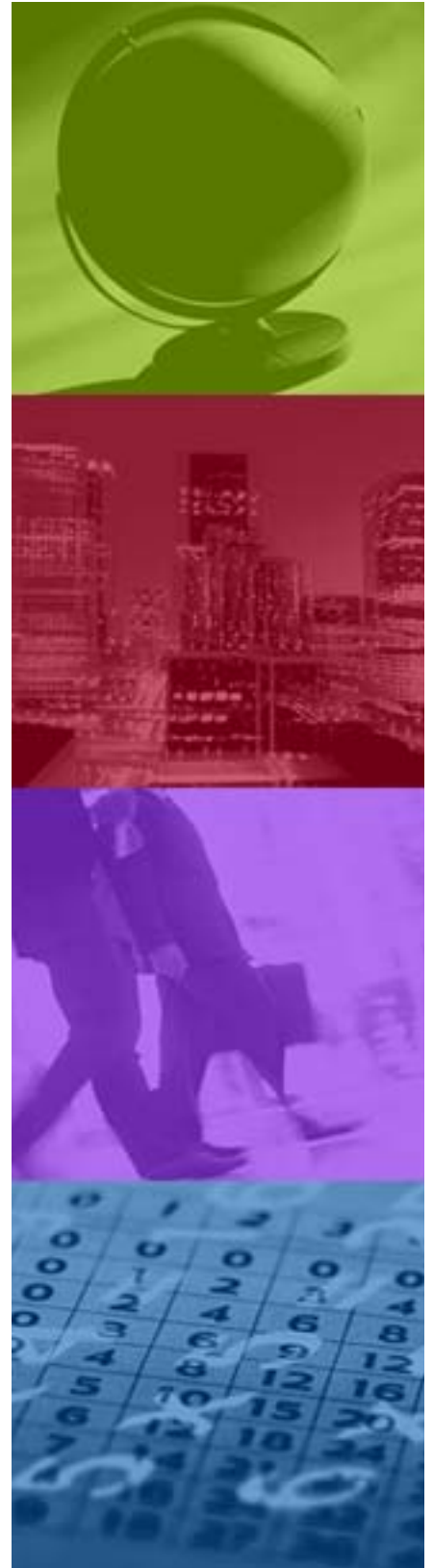
Current Trends White Paper Series

Nearshore vs. Offshore Sourcing

Relative risks, rewards, and economic outcomes

SYNOPSIS: It is generally assumed that companies can save significantly more money by moving jobs offshore to developing nations than they can by deploying to lower-cost domestic locations. In fact, when all of the critical economic factors such as wage inflation, productivity, and management overhead are considered, many domestic locations sometimes offer savings that are comparable to, or even better than, offshore locations.

The trend of relocating non-core business functions offshore to developing nations such as India and China continues to gain momentum. However, mixed among many well publicized successes are reports of unexpected costs, managerial strain, and cultural barriers to effective operations from offshoring. This begs the question, "What determines whether relocating offshore will meet with success or failure?" The answer lies less in program implementation and more in thoughtful due diligence about precisely which functions are suitable for moving offshore - particularly to a developing country. Commoditized functions that require more generic and easily acquired - and replaced - skills will continue to be strong candidates for offshore relocation. In contrast, more complex functions, especially those that employ industry-specific knowledge, information security risks, and/or discretionary decision making, will have markedly different savings and risks profiles, and therefore merit careful scrutiny before relocating to an offshore site. For these functions, it is prudent to consider a nearshoring strategy, which can offer access to the requisite skills, and the mitigation of information risk and management burden, while still providing savings that are comparable to - and possibly even better than - offshoring in the long-term.





Deployment and Outsourcing: Two Paths to the Same Destination

Dramatic advances in information technology during the last two decades have allowed organizations to separate core from non-core activities, thereby permitting firms to focus on the former in the service of generating revenue and reduce costs associated with the latter. Two common strategies for reducing costs related to non-core functions are physically relocating them (i.e., deployment) and farming them out to service-provider vendors (i.e., outsourcing). Both deployment and outsourcing are strategies that can be used to capitalize on geo-variability in cost structure by relocating functions to more cost-attractive locations; deployment does so directly by establishing captive centers in such locations and outsourcing does so indirectly by contracting with service-providers that operate in such locations to maximize their own margins. Deployment and outsourcing can employ either an offshore or nearshore strategy, based on the location to which functions are relocated or the location of outsourcing service

providers. For example, offshore deployment typically denotes relocating functions to another continent (e.g., from the U.S. to Asia or Eastern Europe), whereas nearshore deployment generally refers to an intra-continental relocation (e.g., from the U.S. to another U.S. location, Canada or Mexico).

Initially, IT Services were the focus of most firms' offshore deployment and outsourcing efforts. Such efforts were accelerated at the height of the internet boom, when the scarcity and expense of IT talent in the U.S. compelled firms to look abroad to support their businesses, as well as for special projects such as Y2K preparations. However, the scope of functions that have been deployed or outsourced offshore has continued to expand to Business Process Outsourcing (BPO)/IT Enabled Services (ITES), a broad category of functions that include a great variety of support roles, ranging from answering customer queries in a call center to sophisticated financial analysis.¹ Exhibit 1 lists some of the functions and activities that have been moved offshore in recent years.

Exhibit 1: Examples of Functions/Activities that have been Relocated to Offshore Sites

- Accounts Payable
- Accounts Receivable
- Animation
- Applications Development
- Call Center Activities
- Cash Management
- Check Processing
- Collections
- Complaints Handling
- Credit Card Processing
- Customer Queries
- Data Processing & Management
- Database Marketing & Management
- Dealer Billing
- Digitization
- Financial Analysis
- Fixed Assets Accounting
- Geographic Information Systems
- HR Services
- Insurance Claims Processing
- Internal Accounting
- Internet-based Help Desk
- Investor Reporting
- Invoice Processing
- Loan Processing
- Loan Servicing
- Loyalty Program Administration
- Medical Transcription Processing
- Mortgage Processing
- Network Management & Maintenance
- On-Line Education
- On-Line Reservations
- Payments Research
- Payroll
- Reconciliations
- Revenue Accounting
- Securities Research
- Tax Preparation
- Telemarketing
- Telesales Support
- Voice-based Help Desk
- Website Services & Applications

¹ Although technically there is a distinction between BPO and ITES, as the former applies to all business support functions and the latter is specific to those that are mediated by technology, these two terms are often used interchangeably.

Offshore Deployment and Outsourcing: Present and Projected Markets

There has been a veritable explosion in relocating functions to offshore locations, whether through deployment or outsourcing arrangements. This trend has been reflected macro-economically in the sectoral redistribution of foreign trade in the U.S.; services imports have grown from 14% to 17% of total imports between 1980 and 2003 (Bureau of Economic Analysis, U.S. International Transactions Accounts Data).

There is a wide range of projections about the potential growth of the offshoring services industry globally in the near- and long-term. For example, McKinsey estimates that the BPO industry world-wide was roughly \$32 billion to \$35 billion in revenue in 2002, and projected to grow at a rate of 30 to 40 percent per year for the next five years (Agrawal, Farrell, and Remes, 2003). If these projections are realized, the size of the global BPO market will be well in excess of \$100 billion in annual revenue by 2008. Even

McKinsey's bullish outlook is conservative relative to that of other organizations. For example, Deloitte Research predicts that spending on off-shoring will grow to more than \$260 billion by 2010 (Gentle, 2004). It is likewise difficult to tally the number of U.S. jobs that have moved overseas from offshore deployment and outsourcing initiatives. Widely disseminated figures from Forrester Research hold that approximately 830,000 jobs will have moved offshore by year-end 2005, and that this total will grow to 3.4 million by 2015 (McCarthy, 2004).

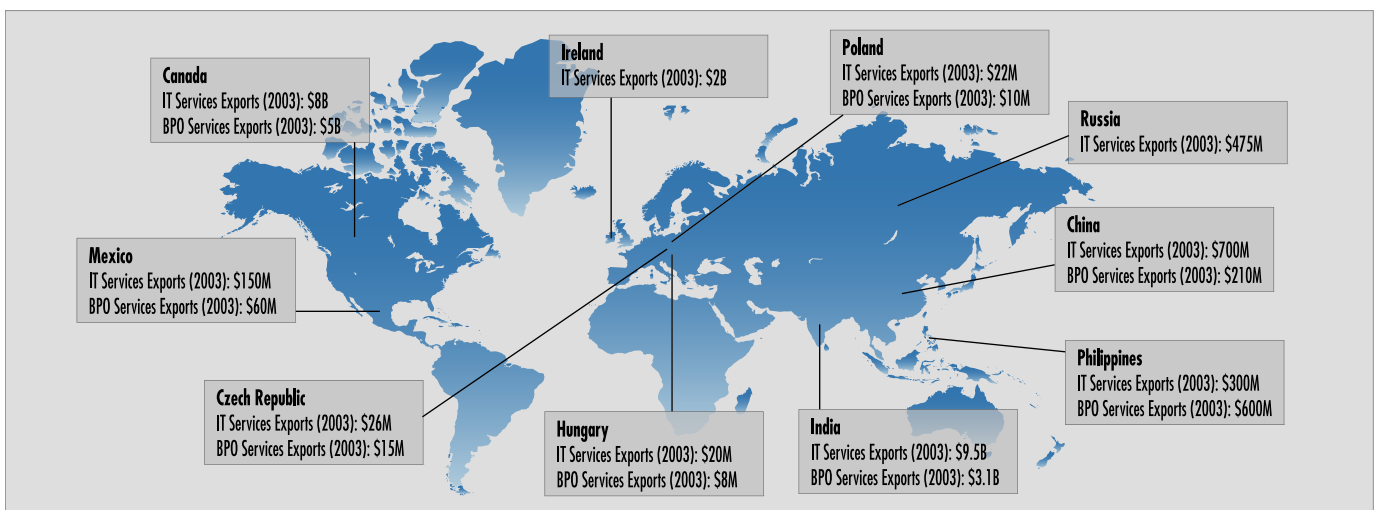


Offshore Destinations: Established and Emerging Host Locations

Since the dawn of offshoring as a cost cutting and sourcing strategy, India has been the location of choice for many of the US and UK firms that have undertaken such initiatives, largely because of its supply of relatively inexpensive English-speaking workers. Recently, however, other countries are emerging as competitors, as is illustrated in Exhibit 2.

To a certain extent India has become a victim of its own success, as explosive

Exhibit 2: Schematic Map of Select IT and BPO Services Export Markets by Country of Origin



Source: neoIT, Inc.; Offshore Insights White Paper. Mapping Offshore Markets Update, June 2004.



“Unfortunately, many offshoring decisions are made without considering alternate options, such as nearshoring...”

growth in demand for IT and ITES/BPO services has resulted in heated competition for talent and, consequently, steep rates of wage inflation. Reports of insufficient supply in IT and ITES skills abound, and in the absence of a revolutionary re-tooling of the educational infrastructure, considerable shortfalls in these skills will follow. For example, a recent NASSCOM-KPMG study concluded that a shortfall in IT and ITES/BPO skills of 500,000 workers is expected by 2009 (NASSCOM Newline, 2004).

Other organizations agree. "Assuming a supply of 40,000 decent IT engineers a year, McKinsey's Diana Farrell thinks that India will 'not even come close' to meeting the demand for one million offshore IT and software workers her company forecasts for 2008" (A World of Work, The Economist, 2004). Not surprisingly, many firms - including major Indian service providers - have recently turned to other countries, principally in Asia, Eastern Europe, but even the United States (for high-end skills) for more favorable labor market conditions. For example, Infosys Technologies, Tata Consultancy Services, and Wipro Technologies have all established applications development and maintenance operations in China (Rai, 2004).

The Less Obvious Costs of Moving Functions Offshore

Offshoring can be highly effective ... in some situations, for some companies, and for some functions. However, there are many situations in which alternative solutions exist, solutions, moreover, that have lower risk profiles and operational complexity but still provide very significant savings relative to the status quo.

It is all too easy to ignore the tremendous challenges and risks that accompany offshoring to a developing world venue: vast distances and time-zone differences, striking cultural issues, logistical challenges, weaker intellectual property rights protection, regulatory requirements, language differences, complex and uncertain legal and political environments, etc. The savings gained from deploying work to

economically developing countries do not come without a price; there is a risk-reward equation to consider. It is not unusual - in such instances - for the savings gained from an offshore solution over-and-above those of a nearshore solution to be less compelling when this added risk and complexity are fully considered. Unfortunately, many offshoring decisions are made without considering alternative options - such as nearshoring - that, because of less operational complexity, risk, and disruption might ultimately be more attractive.

Furthermore, these offshoring decisions are frequently made based on economic models that fail to incorporate the full scope of variables that must be considered to confirm both the immediate benefits and those likely to accrue over time. This exposes one to the risk of vastly overstating savings levels, misrepresenting the sustainability of those savings, and ultimately choosing an option with a poor risk-reward profile. It is critical to instead evaluate offshore deployment relative to alternative options, and to do so in as comprehensive a manner as possible.

Static Wage Differentials

Time and again firms that approach us for advice about offshoring start out with highly unrealistic expectations of the savings that can be achieved from such an initiative. These expectations are usually based on either information of dubious validity or vintage - typically from popular media outlets - or from internal analyses that fail to focus on the segment of the offshore labor pool that is actually required for the functions being considered for those markets. Forming an accurate, apples-to-apples comparison of current static compensation levels is critical.

One approach that can overstate the savings opportunity from offshore deployment is assuming that the price for very general skills within a specific function generalizes to specialized skills within that function. For example, the market price for a generic accountant with knowledge of basic FASB accounting practices will - not surprisingly - show a wide spread between

U.S. and Philippine markets; this is the sort of spread that often makes its way into the popular press and is used to justify deploying functions to developing countries. If one were to look for specialized skills within this function, such as fund accounting on the low-end and accounting for over-the-counter structured financial products on the high end, the spread diminishes (if it does not reverse outright). The reason for this is simply the supply-demand dynamics in developing countries that, by nature of having developing economies, do not produce comparable pools of talent - in quality and quantity - as developed countries. This is not to say that the same specialized/esoteric skills are ubiquitous in developed countries. Rather, they are simply more prevalent, and in those locations where they are not available in sufficient numbers the market can attract them (in contrast to the developing countries, where a relocation from developed countries is - to put it mildly - a hard sell). It must be emphasized that this is particularly germane for highly specialized functions, such as complex analytics,

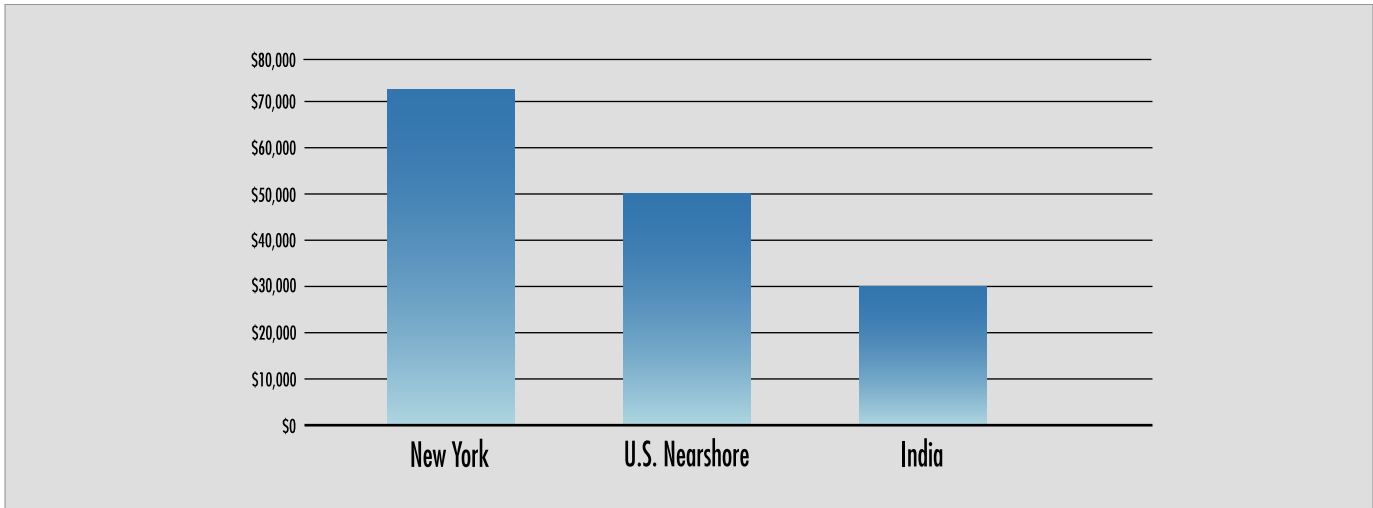
research and development, high-end processing, and sophisticated software development.

After rational estimates of an offshore compensation cost structure are obtained, the next step is to understand what other location alternatives exist, identifying the risks and operational nature of these alternatives, as well as their respective cost structures. It is not unusual that, when all of the relevant decision-making factors are considered, nearshore options offer a sourcing alternative that is ultimately a better operational fit than offshoring yet still provide very attractive economic benefits. These benefits, when loaded with both the surface-level and less obvious costs of staffing, are often comparable to offshoring, and can in fact be better.

Compensation differentials taken from current case studies, such as those shown in Exhibit 3, can help clarify the differences in the true costs of sourcing in select U.S. and Indian labor markets for high-end skills. The data in Exhibit 3 illustrate a comparison of annual per capita compensation costs for a set of jobs currently residing in New York and being considered for deploy-



Exhibit 3: Baseline Wage Differentials: Average Annual Compensation for Applications Developers with 3 to 5 Years of Experience (2004)





“It is not unusual that...nearshore options offer a better operational fit than offshoring yet still provide very attractive economic benefits.”

ment to either a U.S. nearshore location or India. The New York baseline represents average compensation for a set of applications development jobs being considered for deployment by a leading investment bank. The nearshore baseline derives from a detailed examination of compensation levels (involving multiple salary surveys as well as detailed interviews with local "blue chip" employers-of-choice) in a major U.S. IT center in the Eastern Time Zone that has abundant pools of the skills sought by the New York-based firm, and the offshore (India) baseline represents actual payroll data from top tier firms in Mumbai employing the exact same skills required by this prospective employer. Clearly the savings resulting from deployment to India are highly attractive. On a per job basis, this firm would save 58% on compensation (right now ... more on the long-term prospects in the next section). But, the firm could also save 30% by moving to an alternate U.S. location, be within two-hours travel from headquarters in New York, operate entirely in the Eastern Time Zone, and more effectively manage the operational risk associated with moving the functions by also moving key individuals with institutional knowledge to the new location (something it is virtually impossible to do in any quantity when deploying offshore to a developing nation).

It is critical for decision makers to ask difficult questions when considering a remote sourcing initiative. Do the added savings that result from going to the developing world outweigh the advantages of moving to a nearshore location in the U.S., albeit at a somewhat reduced savings rate? Have the economic analyses used to assess each business case gone far enough? Specifically, have the relative costs associated with each option been adequately compared? Without factoring in differential rates of wage inflation, relative workforce productivity rates, turnover, management and administrative burdens, foreign exchange rates, and a host of other factors, the answer is a resounding "no".

Wage Inflation

Steep wage inflation is perhaps the most

obvious structural change that is affecting the Indian off-shoring proposition. According to Hewitt Associates Inc., salaries in India inflated by 14 percent in 2003, whereas the increase in the U.S. was 3.3 to 3.5 percent (Overby, 2004). "Hewitt expects Indian salaries to rise by another 13% this year" (Fleming, 2004). Projected long-term demand for services in India - coupled with substantial shortfalls in supply - suggest that wage inflation rates of this magnitude will be sustained if not elevated in the long-term. Thus, when assessing the true savings related to relocating functions to India over the long-term, it is imperative to account for differential wage accretion rates rather than simply assessing the current spread in wage rates for specific skills between Indian and domestic markets.

Exhibit 4 illustrates the impact of differential wage inflation rates over time (this example is based on the same case shown in Exhibit 3). The lines represent the difference in savings achieved over time by deploying from New York to a U.S. nearshore alternative relative to those achieved by deploying to India. Three different lines are shown, each based on a different "spread" in inflation rates between the nearshore and offshore alternatives.

In all cases deploying in 2005 to the nearshore location results in approximately \$22,000 (fully loaded) less in savings per job than deploying to the offshore location. Of course, as shown previously in Exhibit 3, it is important to keep in mind that the nearshore deployment is still saving over \$21,000 per job relative to staying in the current location. Savings are still substantial by deploying nearshore, but the employer is not accruing an additional \$22,000 in savings that could have been achieved offshore. However, over time, as the differential rates of inflation are applied, the cost advantage of offshore deployment shrinks and, in some cases, even eventually disappears. For example, the orange line represents an 11% spread in inflation rates between near-and offshore options, reflecting the recent differentials that have existed between the two markets.

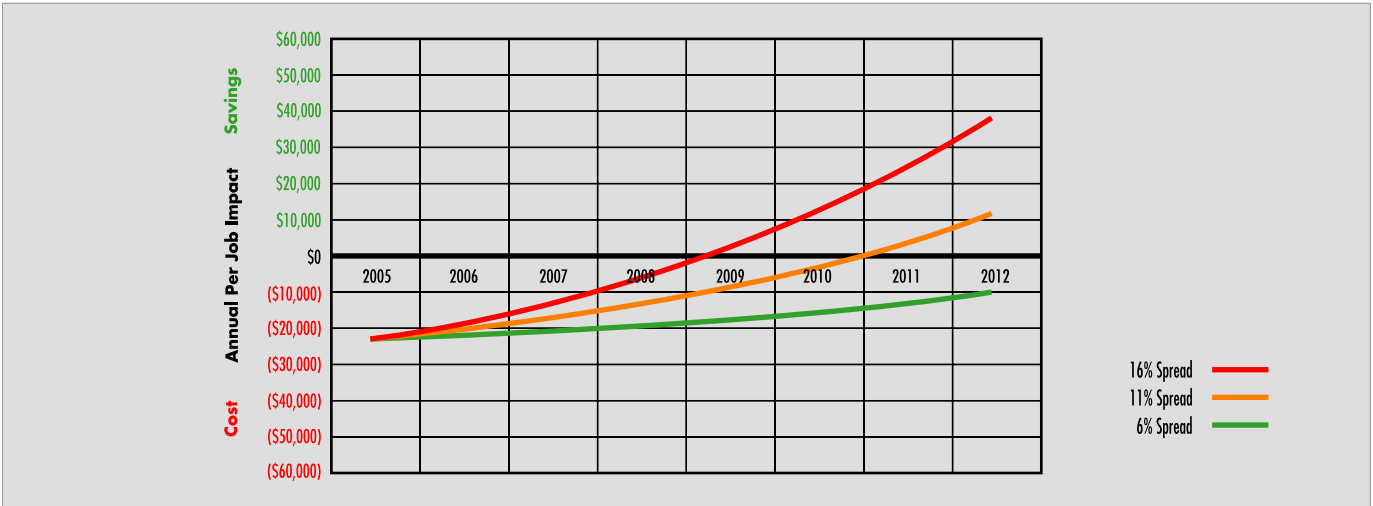
Over time the cost advantage of offshore deployment steadily declines until, by 2011, the per capita cost of offshore labor is actually higher than nearshore labor. If the incremental inflation levels in an offshore location are greater (as shown by the red line representing a 16% spread in line with some of the forecasts that have been made recently) the rate at which the advantage decreases is accelerated.

Is it reasonable to assume that these exact rates of inflation will continue? Ultimately, there is no way to really know. If a purely rational perspective were taken by current and potential market participants, then the answer would likely be "no." As inflation continues in the near-term and wages continue to rise, employers would - in an entirely economically rational world - temper the amount of employment demand they channel into the Indian market. Lower demand, in turn, would serve to mitigate the continued upward pressure on wages in the local market. Two caveats related to these dynamics must be kept in mind. First, this level of rationality is seldom applied presciently or proac-

tively ahead of a trend. Rather, macro-economic corrective behavior tends to occur as a response only when the "pendulum has swung too far." Moreover, dramatic gains in income levels - and resulting elevation in living standards - create expectations among workers that lead to upward pressure on wages independent from labor supply-demand dynamics or economic cycles (e.g., Japan post-WWII through the 1970s and China presently). Specifically, when workers transition from a subsistence-level existence to one in which some measure of disposable income is attained, the expectation of continued (relative) prosperity soon develops, and it is very difficult for workers to accept financial stagnation or regression. This, in and of itself, will not generate upward pressure on wages, however, as workers become more sophisticated in their understanding of employers' implicit reliance on maintaining their existing workforce - even in the face of rising labor costs - in order to avoid the greater cost and disruption involved in even a phased decommissioning and deployment to a new venue, there is both considerable



Exhibit 4: Per Capita Cost-Savings of Nearshore (U.S.) Deployment vs. Offshore (India) Deployment with Varying Wage Accretion Spreads: Applications Developer with 3 to 5 Years Experience



Note: Accretion spread based on India accretion levels of 10%, 15% and 20% vs. Nearshore at 4%



motivation and recognized ability for workers to demand greater compensation.

The bottom line is that the analyses shown in Figure 4 frame the "bet" that an entrant to this market is making. There will be a trend towards significant wage inflation. The exact rate over the long-term, while unknowable, is dependent on the behavior of other market participants and the trajectory of virtually inevitable macro-level societal trends; both factors completely beyond any individual market participant's control. Therefore, one must be resigned to the fact that the marginal economic benefit of India relative to a near-shore location will contract over time, and the rate and degree to which it will contract is likely to be significant but fundamentally unpredictable and beyond an individual employer's control. The key is to assess the likely trend, the resulting long-term relative economics of the various options, and assess whether an offshore option truly provides enough incremental savings to outweigh the advantages inherent in a nearshore option.

Worker Productivity Levels

Differential rates of worker productivity between domestic and offshore markets will also impact the savings pro forma. If worker productivity in an off-shore location is lower than that of domestic productivity then more resources will be needed in the former, which will obviously have a deleterious impact on the savings gained from moving functions offshore. Comparatively lower productivity in offshore markets can have several causes, from cultural differences that negatively affect the efficacy of call center staff to lesser training and/or experience for more highly skilled positions. An example of the latter comes from the case of Bladelogic, a Waltham, Massachusetts-based software firm that decided to repatriate work sent to India because it "could be done faster and at a lower cost in the United States" (Porter, 2004). This counterintuitive notion that IT Services sourced in the U.S. can in fact be cheaper than those sourced in India demonstrates the magnitude of the

economic impact that differential productivity levels can have.

The effect of differential rates of productivity between offshore and nearshore IT labor markets is illustrated in Exhibit 5 (based on the same case study described in Exhibits 3 and 4). The curves show the impact that differing relative productivity levels have on the economic outcomes related to offshore and nearshore deployment, both immediately (prior to any impact from wage accretion) and at two later points in time as the wage inflation trends discussed in the previous section come into play (in this case, the analyses assume an 11% wage inflation differential).

As shown in Exhibit 4, in 2005 (shown as the green line in Exhibit 5) deploying to India results in an added \$22,000 (fully loaded) per job in savings over-and-above what can be achieved by deploying to the nearshore U.S. location. However, this assumes that the same productivity level can be achieved in India as can be achieved in the U.S. (Point A on the graph). Any productivity deficit in India will result in a decrease to these incremental savings. For example, if productivity in India were only to reach 80% of that in the U.S., the additional savings in 2005 would shrink to just over \$10,000 per job (Point B). If productivity were to shrink to 65%, then essentially we have reached a point at which the two scenarios - U.S. vs. Indian deployment - are cost neutral (Point C). There are no added savings generated by deploying to India instead of deploying to a nearshore U.S. location. Anything short of 65% relative productivity in India will result in the Indian deployment program being less economically beneficial than a U.S. nearshore alternative program.

The 2005 line shows the current state, with no added impact from differential rates of inflation. When current wage inflation differentials (i.e., 11%) between India and the U.S. nearshore market are carried forward in this analysis, the productivity bar is raised. By 2008, productivity in India must be at approximately 82.5% of that achieved in the U.S. in order

for the two options to be cost neutral (Point D). At any productivity level below that, greater economic savings are achieved in the U.S. By 2012, were current inflationary trends to continue, productivity in India must exceed productivity in the U.S. by approximately 12% in order for the two options to be cost neutral (Point E).

In the context of reports of comparative productivity between U.S. and Indian workers performing increasingly complex functions, these are aggressive productivity goals merely to break even. What productivity level is likely when staffing functions in a developing country that is distant from the primary businesses it supports? This ultimately must be addressed on a case-by-case basis. However, extensive discussions with those who have implemented such strategies have been informative. It is exceedingly rare to find organizations that have experienced rates of productivity even approximately comparable to that of the location from which the jobs were deployed - even after very significant periods of extensive training and then years of sustained operations in the new locale. At

the extreme end, some organizations have achieved productivity levels as high as 65% of that of the origination point. In most cases, estimates range from 35% to 50% productivity relative to the origination point. In contrast to these experiences with offshoring, it is rare to find employers who have deployed to carefully chosen nearshore locations that have not achieved productivity levels equivalent to that of the origination point.

Turnover

Another cost associated with competition for human resources is related to staff turnover. The costs of employee turnover relate to recurring productivity losses and the attendant costs of filling vacated positions (e.g., recruiting, screening and training). In India, "... the competition has become so fierce that typical Indian operations in business processing ... can expect to lose 15 to 20 percent of their workforces each year. ... In some sectors of the outsourcing market, attrition rates are 50 to 75 percent a year, according to Sunil Mehta, Vice President of the National

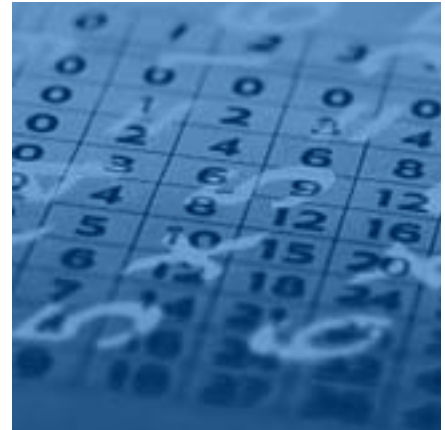
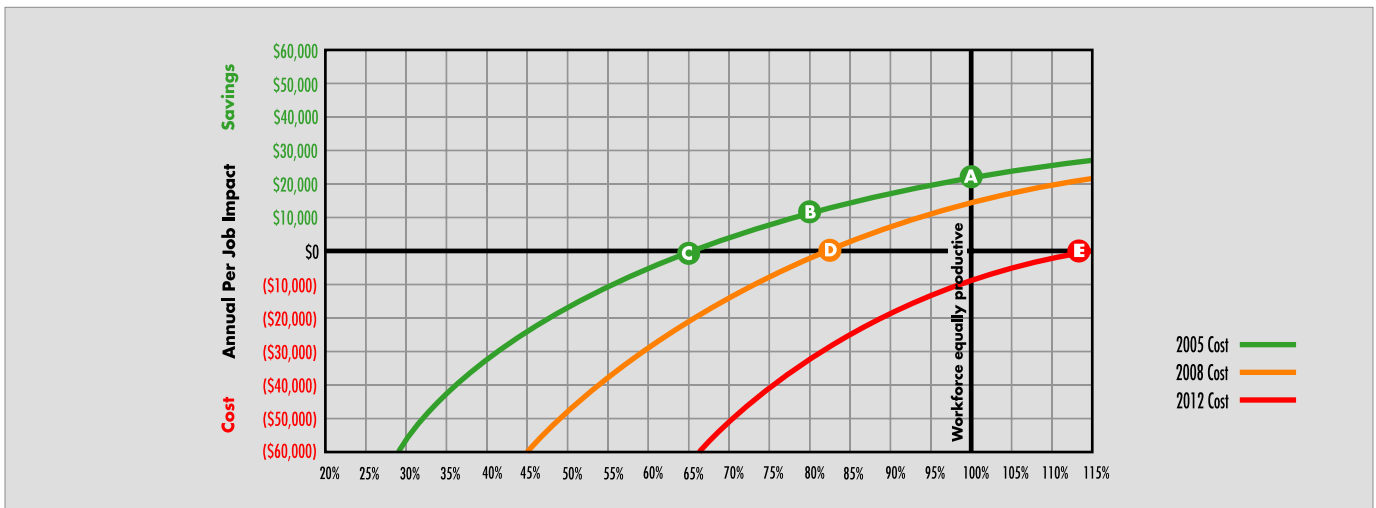


Exhibit 5: Per Capita Cost-Savings of Offshore (India) Deployment vs. Nearshore (U.S.) Deployment as a Function of Varying Productivity Levels: Applications Developer with 3 to 5 Years Experience, Wage Accretion Differential 11%





Association of Software and Services Companies, or NASSCOM, an industry trade group in India" (Scheiber, 2004). When offshoring involves largely routine, commoditized tasks with minimal training invested in each worker, turnover has little real economic or operational impact. The time required to replace the workers that have left is minimal - as is the cost of training their replacements - and the time it takes replacements to reach full performance/productivity levels is short. As the functions being staffed offshore become more complex - and the skill requirements of workers and the time necessary to train them become greater - turnover is no longer a minor consideration.

Management/Administrative Overhead

An additional disparity between offshore and nearshore deployment that must be accounted for in order to achieve a comprehensive economic pro forma is related to management overhead.

It is often assumed that the management structure at the origination point will not change and that little added management/administrative overhead will be required in the new offshore location. A typical expectation is that the new offshore location will require an on-site, typically administrative, site manager along with a very small number of additional administrative staff. Further, the line management remaining in the original location will oversee and manage the actual functions and processes performed in the new location remotely, often from many time-zones away. This may be true for simpler, commoditized functions, but is simply not the case for complex and/or specialized functions.

Factors such as extensive time zone differences between deployed functions and the groups they support at the origination point (both front- and back-office), excessive travel time, and substantial cultural differences impose a heavier management burden on the firm. For example, if a functional team that requires team members to routinely make discretionary decisions at the origination point is disbanded

so that half of the roles can be deployed to a distant location, it is likely that additional line management resources will be required for oversight at the deployment location. Even assuming equivalent productivity between the origination point and the deployment location, additional resources will have to be acquired to manage the deployed sub-unit on-site, resulting in a net add of (managerial) resources from deployment. If the same deployment occurred at a nearshore location, to which managers could travel quickly and spontaneously, the requisite number of additional management resources from deployment will be lower and quite possibly - depending on the function and the near-shore location - no additional resources will be required.

Additional economic disparities between offshore and nearshore deployment exist, such as travel, real estate, construction, utility, and telecommunication costs, foreign exchange rates etc. In short, one must look beyond surface level compensation differentials as a measure of the potential savings opportunity afforded by a deployment initiative; it is imperative that one look at the less obvious incremental costs, and from a dynamic and long-term perspective.

Summary

It is important to understand the societal and macro-economic trends that make an offshore location attractive for sourcing work, as these trends can provide insight into whether the qualities that make the location attractive are sustainable over the long-term.

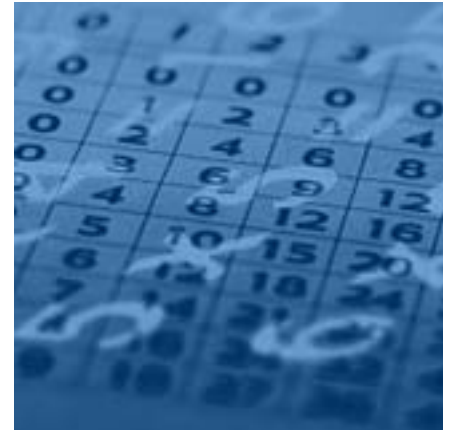
India serves as a relevant example because of its position as the dominant offshore services market. The boom in offshore services that India has enjoyed is due to its inexpensive English-speaking workforce. The low cost of Indian labor relative to that of the economically developed countries of the West is due to the fact that the Indian economy is still in the process of rising from third world status and that its supply of human capital is vast (over 1 billion). What has to be kept in mind is that the true size of the employable workforce

proximity requirements may not be a simple task when evaluating functions that are presently proximate to other functions with which they interact. A simple heuristic for doing so is to determine the importance of prompt face-to-face interactions in a crisis situation. Some tasks are basic enough that system failure can be remediated via telecommunications, or of low enough business value that remediation can be put off long enough to accommodate extensive travel. In contrast, there are countless other functions that, although they are not core activities, are of sufficient complexity and business value that they require on-site and timely remediation in order to avoid substantial revenue or client loss.

A related factor is the extent to which a function being considered for deployment is sensitive to time zone differences. At the risk of again stating the obvious, the more that this is the case, the less suited a function is for offshore deployment. Whereas this may be obvious, the consequences of moving certain functions to distant time zones may not be. For example, business processes that are considered for deployment to a distant offshore location which must work synchronously with functions that are not candidates for deployment may require shift work at the offshore site. Although not a scarcity in offshore locations, shift work does lead to higher turnover than standard working hours, and one should factor in additional costs and business continuity issues that are a consequence of additional turnover (especially when turnover during standard business hours is high, as is presently true in India). Organizations can tolerate turnover, in fact a certain amount of turnover is beneficial because new staff bring new approaches to problem solving, but every organization can tolerate only so much.

There are certainly other factors that can render offshore deployment inappropriate for an organization, perhaps the most widely reported being the impact of cultural differences in communications with offshore staff or between offshore staff

and the customers that they serve. These are too numerous to discuss in detail here, but taken together these factors, which will directly affect business operations in an organization's deployment facility, can be - indeed, often are - as salient in the decision making about deploying functions offshore as cost reduction. Reducing costs from offshoring will have to be re-evaluated if the effort to do so inadvertently reduces revenue, especially with the specter of a costly return of functions looming in background. Although deploying functions offshore will certainly continue - perhaps not at the super sonic rate predicted by some - as the paroxysm to do so continues to subside, organizations are coming to realize that deploying functions to offshore locations is not the best strategy for all deployable functions. Rather, evaluation should be done on a function-by-function basis, and in the case of functions that should not or can not be deployed offshore, there are viable nearshore options that offer compelling - if not comparable and even more attractive - savings rates.



“Reducing costs from offshoring will have to be re-evaluated if the effort to do so inadvertently reduces revenue, especially with the specter of a costly return of functions looming in the background.”



“It is also critical to realize that offshore and nearshore strategies are not mutually exclusive. For many companies ...one particularly attractive approach involves a mix of both strategies.”

tion strategy for corporate America. However, the savings opportunity will vary depending on the complexity, industry-specific specialization, and risk profile of the functions that are considered for moving offshore, particularly in the case of deployment to captive centers rather than outsourcing. The least complex functions will have a fairly straightforward savings profile, one that is reflective of more generic skills that are relatively easy to acquire (and replace) and manage over a large geographic distance. The savings profile for more complicated functions will have a markedly different profile and in some cases less savings than that offered by nearshore deployment opportunities. For these strata of functions, a surface level comparison of compensation differentials between the baseline (i.e., the origination point) and potential offshore and nearshore locations will be misleading.

It is also critical to realize that offshore and nearshore strategies are not mutually exclusive. For many companies - especially large, complex corporations with a wide range of functions and processes - one particularly attractive approach involves a mix of both strategies. A number of our clients have implemented solutions in which routine, highly structured functions with low risk profiles were deployed to an offshore location (either captive or outsourced) while high value-add, complex, mission-critical functions and processes were deployed to a nearshore location. The offshore component provides a sourcing platform providing maximum sustainable savings when the correct functions are channeled there. At the same time, the nearshore component ensures significant savings (often only marginally less dramatic than if those functions were moved offshore) that can be sustained long-term, proximity to headquarters, time-zone consistency or proximity, little/no added risk relative to the status quo environment, and a more suitable labor pool.

Beyond the Buck: Other Factors to Weigh in the Consideration of Deployment

The actual savings from offshoring cer-

tain functions may be enough to cause reflection about whether this sourcing strategy should be implemented, but there are other factors that also have to be weighed in this decision. Again, this assessment must be done on a function-by-function basis. In some industries, such as Financial Services, there may well be regulatory issues that have to be considered for specific functions. Such issues are not always explicit, rather they require dialogue with regulators. For example, after the September 11th attacks in New York, a group of federal agencies that included the Federal Reserve and the SEC put together a series of white papers that strongly recommended enhancement of business continuity/disaster recovery plans to ensure the liquidity of the capital markets in the event of another cataclysmic event. Although no mandates have been issued, the federal government continues to take a keen interest in this matter and, while geographic separation of securities execution and transaction processing functions is encouraged, plans to relocate the latter offshore would likely inspire strong reactions because of the introduction of additional operational and geopolitical risks.

Another factor worthy of consideration involves information security. Maintaining network security and protecting intellectual property are major concerns in the developing world. A widely known example of the latter is the theft of source code and design documents reported by Jolly Technologies in its recently opened R&D facility in India (Ribeiro, 2004). Although such a crime is by no means unique to India, and India has established adequate intellectual property laws, enforcement of those laws has proven to be challenging. Perhaps even more distressing are the risks attendant with moving functions that require access to high value client information, such as institutional securities trading activities.

Although painfully obvious, it is worth mentioning that organizations must think long and hard about the proximity requirements of functions that they are considering deploying. Objectively understanding

in IT and ITES/BPO services is but a fraction of the total workforce because India's educational infrastructure is not universally available. In fact, India continues to have third world illiteracy rates (32% of adult males, 55% of adult females) and the average number of years of education in India is a little more than five (World Bank, 2002). This accounts for why the recent increase in demand for IT and ITES/BPO skills in India has strained the Indian labor markets despite the size of the total population. As noted above, the strong growth in demand for IT Services and ITES/BPO skills in India has resulted in heated competition for those skills, and consequent sharply increasing wage inflation (e.g., 13% - 14%) and employee turnover (15% - 20%) rates. This pattern is not unique to India. As other developing nations have undergone similar changes in the past, similar dynamics arose, and it is not unreasonable to expect that other emerging market economies will do the same.

As a developed-nation nearshore point of comparison, Canada, which has a fraction of India's population but a world-class educational infrastructure, has benefited from stable (i.e., similar to the U.S.) wage inflation and turnover rates, despite having a BPO export market that is greater than India's (\$5 billion vs. \$3.1 billion; neoIT, 2004). Similar to Canada, historic and projected wage inflation and employee turnover rates in a host of viable nearshore markets in the U.S. are dramatically lower than those of India, and must be reflected in a comparative analysis of the long-term economic impact of Indian offshore and nearshore deployment. To summarize, if these wage escalation trends in India continue at anything even approximating current rates, the savings opportunity will shrink significantly. It is even possible that, on a productivity-adjusted basis, over the medium-term India's labor costs may exceed those of some alternative markets in developed countries.

The objective of deployment and outsourcing initiatives is first and foremost to reduce costs, and doing so via an offshore strategy can optimize savings. However, as described above, there are numerous hid-

den costs associated with offshore sourcing of work. When these costs are fully factored into a long-term economic view, the savings profile of offshore sourcing relative to nearshore sourcing can change - depending upon the functions considered for deployment - markedly. The savings rates from offshore deployment that are often bandied about are as high as 70 to 80%, based on current compensation differentials between domestic and offshore labor markets. However, these differentials usually derive from the lowest level skill sets, and make no provisions for the manifestations of different labor market dynamics discussed above, such as differential wage inflation, turnover, and productivity rates. Achievable savings from outsourcing to India, for example, are typically less than half of the compensation differential (Scheiber, 2004). Thus, even if the much ballyhooed compensation differentials of 70% to 80% are taken as a given (and assumed to be static), the true savings rate from offshoring would net 35% to 40%. This savings rate is substantial, but would only hold if comparable productivity rates were realized. In reality, differential productivity would further reduce the savings rate, well below 30% for some functions. It is important to note here that, relative to business capitals in North America and Europe such as New York, San Francisco, and London, savings rates in excess of 30% are achievable by implementing a nearshore sourcing strategy. (In such cases, the benefits of proximity, minimal - very often no - time zone differences, ease of travel, and cultural homogeneity are add-ons to the savings proposition). This view is echoed by Tom Weakland of DiamondCluster, who noted recently in *Business Week*, "A Russian programmer charges 80% less than an American. But when you parse it all out, the total cost of offshoring a given IT job is generally comparable to getting the work done domestically" (Kharif, 2003).

None of this is to say that moving functions offshore cannot work. The size and dramatic growth of offshore services industries testify to their import as a cost reduc-



"When these [hidden] costs are fully factored into a long-term economic view, the savings profile relative to nearshore sourcing can change...markedly."



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