STRATEGIC PLANNING

Getting Offshoring Right

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In 2003, Alpha Corp., a well-known U.S.-based organization, offshored and outsourced several customer-retention processes. When the company found that some of its customers seemed likely to switch to rivals, it provided data on them to an outsourcing firm in India. The service provider called those customers and, on Alpha Corp.'s behalf, offered them fee waivers, upgrades, and free financial products as incentives to remain with Alpha Corp.

A common, but rarely discussed, offshoring scenario then played out.

The vendor's employees were enthusiastic, but they didn't have much experience selling sophisticated financial products such as disability and loss-of-income insurance. As a result, they didn't know how to interpret customers' responses to the incentives they were offering and found it difficult to decide what to do when customers asked them for other incentives. In fact, the provider's employees often placed people on hold in order to contact Alpha Corp.'s supervisors and ask whether to give customers what they wanted.[1] As the demands on Alpha Corp.'s marketing managers rose and the vendor was unable to retain as many customers as it had hoped, Alpha Corp.'s executives began to wonder, "What have we done?"

They aren't the only executives asking that question today. Cut through the hype, and you'll find that, like Alpha Corp., many companies are waking up and smelling the harsh realities of offshoring. Sure, the prospect of offshoring and outsourcing business processes has captured the imagination of CEOs everywhere. In the last five years, many companies

in North America and Europe have experimented with this strategy, hoping to reduce costs, become more efficient, and gain a little strategic advantage. However, contrary to popular perception, many businesses have had, at best, mixed results. According to several studies, half the organizations that shifted processes offshore failed to generate the financial benefits they expected to. Many also faced resistance from employees as well as consumer dissatisfaction. In early 2005, both the Boston Consulting Group and Gartner predicted that 50% of the offshoring contracts that companies in North America had signed between 2001 and 2004 would fail to meet expectations. No wonder the "I" words, inshoring and insourcing, have become almost as popular in business circles as the two "O" words.

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As academics who have studied the subject in several countries, industries, and companies for more than four years, we can't say we're shocked. Most companies believe it's easy to offshore business processes—easier than it was in the 1980s to procure components from global suppliers or to set up manufacturing plants overseas. Businesses therefore don't make decisions about offshoring systematically enough. As a result, they commit at least one of three fundamental mistakes.

First, most companies focus their efforts on choosing countries, cities, and vendors, as well as on negotiating prices, but they don't spend time evaluating which processes they should offshore and which they shouldn't. Without a standard methodology for differentiating processes, most executives find it tough to distinguish among *core* processes that they must control, *critical* processes that they might buy from best-in-class vendors, and *commodity* processes that they can outsource. They endlessly debate the differences between the core and critical ones, and after political tussles break out, diktats from the top mandate that some processes be sent offshore. Companies inevitably make the wrong choices and, after offshoring or outsourcing processes that they think aren't strategic, have to bring some back in-house.

Second, most organizations don't take into account all the risks that accompany offshoring. Executives use simple cost/benefit analyses to make decisions without realizing, for instance, that after they transfer processes, their vendors will gain the upper hand. Providers can hold companies to ransom; it's almost impossible for organizations to reabsorb business processes on short notice. Most organizations naively ignore these latent risks and are shocked when vendors demand price hikes that erode the savings from outsourcing.

Finally, most companies don't realize that outsourcing is no longer an all-or-nothing choice—that they have a continuum of options. At one end, there's executing processes in-house; at the other, there's outsourcing them to service providers. Along that continuum, companies can buy services from local providers (a lot of outsourcing is local), enter into joint ventures, or set up captive centers overseas. Most businesses don't consider all the available options and end up using organizational forms that are inappropriate for their purposes. They also analyze processes too narrowly, looking only at direct costs and failing to examine interdependencies that might tip the cost/benefit analysis in favor of keeping services in-house. Making the right governance choices is critical; our research shows that both location and organizational form decide the fate of offshoring strategies.

Clearly, companies have to rethink the manner in which they formulate their offshoring strategies if they wish to succeed. In the following pages, we'll outline tools that will help companies choose the right processes to offshore, and discuss the associated risks. We will also describe a new kind of organizational structure and show how companies can use it to benefit from offshoring. Don't misunderstand; smart companies have gained strategic advantage by offshoring processes. Your company can also harness the power of the services revolution by taking three steps, one at a time.

Rank Processes by Value

Executives can distinguish, at the outset, between business processes they should and shouldn't offshore by figuring out how each process helps them to create value for customers and to capture some of that value. The relative importance of a process along those two dimensions indicates the risks and rewards associated with moving its

execution outside the organization or country. Executives instinctively know the importance of these criteria but usually don't know how to factor them into decisions about offshoring.

There's a simple way executives can do that. They should answer the question, How crucial is each process (or subprocess) compared with others in creating value for my company's customers? The answers will differ from business to business and, often, by industry. In the consumer goods industry, for instance, executives usually rate product-development processes higher than customer-service processes, while in the hotel industry, the opposite is true. Next, managers must ask, In relative terms, to what degree does each process enable my company to capture some of the value that it has created for customers? They must rank each process along these two dimensions, then add the two rankings together to arrive at a total ranking for each process. Sometimes, executives may feel that one of the two dimensions is more important in the industry or for their company. In that case, they must calculate the total rankings after assigning greater weight to the more important aspect. For instance, retail banks believe that making money is tougher than developing new consumer finance products. They tend to rate the value-capture aspect of their processes higher than they do the value-creation dimension.

By ranking all the company's processes, executives can create a value hierarchy. The higher a process's rank in the hierarchy, the more crucial it is to the company's strategy, and the less the organization should think about moving it offshore or outsourcing it. The hierarchy tells companies where the fault lines between processes are and lays out an offshore migration path. For example, at one U.S.-based computer and communications equipment manufacturer we worked with, senior executives unanimously agreed that of six processes in the finance function, managing the float for suppliers and dealers had the highest relative importance (see the exhibit "Creating a Value Hierarchy of Processes"). That alerted managers that it would be risky to offshore or outsource the process; even if the service provider made only a few errors, it would hurt the firm's dealers and suppliers financially and tarnish the company's reputation. The executives also felt that managing the company's working capital was too important to offshore. At the same time, the group decided that three other processes—invoice verification, payment authorization, and

revenue and expense reporting—were less valuable and that the company could think about offshoring or even outsourcing them. Some of the executives also believed that at a later date, the business could offshore the cash-flow forecasting operation. This analysis became the basis of the company's offshoring strategy, which so far has been successful.

Creating a Value Hierarchy of Processes

Executives in a company's finance department, charged with identifying business processes to offshore, ranked six processes on their ability to create value for customers and on their ability to capture value for the business. They then added the value-creation ranking and the value-capture ranking together to arrive at a total for each process. When they studied the final rankings, or hierarchy, the executives agreed that they could offshore the three lowest-ranking processes; the two highest-ranking processes, they decided, were too strategically valuable to offshore.

Process	Value-creation ranking*	Value-capture ranking*	Total ranking	
Float management for suppliers and dealers	1	1	2	Processes the company shouldn't offshore
Working capital management	2	3	5	
Cash-flow forecasting	4	2	6	
Revenue and expense reporting	3	4	7	Processes the company might offshore
Payment authorization	5	5	10	
Invoice verification	6	6	12	

*Determined by executive consensus

When executives, usually from the same department, sit around a table and draw up a value hierarchy, it serves several purposes. The ranking provides a standard basis for comparing processes across the company, which makes discussions about offshoring more constructive. Executives often rank the same business process differently; drawing up the hierarchy highlights these differences. That helps surface tensions around offshoring decisions. Above all, the value hierarchy allows managers to think systematically about the importance of processes without getting into interminable debates about what the company's core processes are or how critical its critical processes are.

Identify and Manage Risk

Once a company has established that some of its processes can be offshored or outsourced, it must tackle all the risks that could affect their migration. Companies face two very different kinds of risk: operational and structural. The former may be more critical in the initial stages of offshoring and outsourcing, but over time, the latter swells in importance.

Operational Risk.

Smart companies start off assuming that service providers won't be able to execute business processes as well as their employees perform them in-house—at least, not for a long time. Unlike the manufacture of components, firms can't provide vendors with specifications and expect them to carry out tasks perfectly. Until service providers move up the learning curve, they will make more errors and execute tasks more slowly than companies' employees do. That often results in lower customer satisfaction.

Businesses can try to lower operational risk by tackling its twin causes, the first of which is an organization's ability to codify work. When companies document the work that employees do, describe the different situations they face, and stipulate what employees' responses should be in each scenario, people anywhere in the world can do the job for them. For instance, if a European retail bank has drawn up rules about when it will give customers loans, has stipulated the procedures for resolving exceptions to accounting norms, and has laid down when it will hold financial instruments in suspense accounts, managers on any continent can perform those tasks for the bank with minimal supervision. Investment banks can outsource even complex tasks like equity research as long as they codify the tasks involved. However, if a service provider's employees require a great deal of domain experience—information about the client's customers, a deep understanding of how its product and geographic markets function, and knowledge that the client's managers carry in their heads—to execute processes, they are unlikely to get those processes right for a long time. (For more on codifying knowledge in the workplace, see Dorothy Leonard and Walter Swap's article "Deep Smarts," HBR September 2004.)

The second cause of operational risk is a company's use of metrics to measure the quality of processes. Many businesses, we find, haven't developed effective metrics, or they formulate metrics for the first time when they outsource processes. Both increase operational risk because, when such companies offshore or outsource processes, they have no way of knowing if providers have executed those processes better or worse than their employees did. Businesses would do better to create metrics, measure the quality of processes for a while, and improve their quality in-house before deciding to offshore or outsource them.

We cannot stress enough the importance of drawing up metrics; what a firm doesn't measure, it can't offshore well. According to our research, companies that define metrics subjectively usually end up with costly errors and long gestation periods before their providers execute processes effectively. Only firms that set tolerance limits for errors, draw up completion times and productivity norms, and continuously measure employees' performance are able to move processes offshore. In 2002, when Lehman Brothers decided to offshore the development of some information technology–related processes, it identified lower costs, higher quality, and faster deployment of new systems as its goals. The investment bank drew up several metrics that allowed it to measure its service providers' performance along each of those dimensions. Lehman Brothers measured vendors' performance every month and, after a year, found that its providers had exceeded the cost-savings targets while delivering the same quality of execution as the bank's in-house operations. However, the time the vendors took to develop new systems was below expectations. Not only was Lehman Brothers able to take corrective action, but its focus on continuous measurement also allowed it to quickly ramp up its offshore operations, both in terms of volume and complexity.

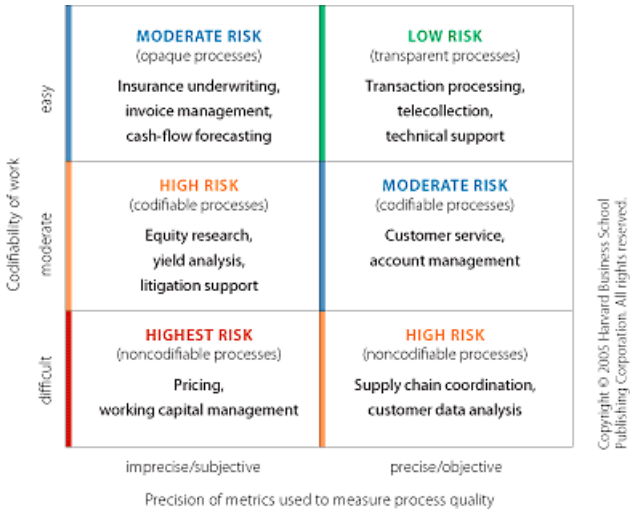
What a firm doesn't measure, it can't offshore well.

Interestingly, the belief that offshoring linear processes—where one person hands off work to another person—poses less operational risk than offshoring processes where work flows back and forth between people is dead wrong. Just because a process is linear doesn't mean that it's easy to outsource. We've seen several linear processes, such as inventory control in consumer goods industries and wealth management–related processes in financial services, that businesses couldn't offshore because they didn't have good metrics to measure process quality. Moreover, our studies show that the nature of information flows doesn't affect the quality of execution. If companies codify work and develop metrics to evaluate quality, they can contain operational risk even if work constantly moves between companies' employees and vendors' agents.

When companies look at the extent to which they codify work and use metrics to measure process quality, they'll see that their processes fall into four distinct categories (see the exhibit "Evaluating Operational Risk").

Evaluating Operational Risk

To evaluate operational risk (the risk that processes won't operate smoothly after being offshored), companies should classify processes by how precise their metrics for quality are, as well as the extent to which work can be codified. We've listed some processes that, our research shows, fall into each category.



Transparent Processes.

Companies have metrics to measure the quality of processes, and they can codify the work. The operational risk of offshoring and outsourcing these processes is very low.

Codifiable Processes.

Companies have some ability to measure the quality of execution and can codify most of the work. Still, only people who have formally mastered a body of knowledge, such as accountants and lawyers, can execute these tasks. It's also inherently difficult to manage the quality of the work in real time. If firms can measure the quality of the end result, the risk of offshoring or outsourcing the processes becomes manageable. However, if measuring the results is difficult, the risk of offshoring becomes very high.

Opaque Processes.

Companies can codify the work, but they cannot measure the quality of process outputs. When firms underwrite insurance policies, for instance, it's difficult for them to measure how well their employees have executed the task since the events that policy buyers are protecting themselves from may never occur. Although the risks of offshoring these processes are moderate, companies have to inspect samples to ensure that the output

meets their quality standards. That's often cumbersome and expensive. If companies specify how the outsourcer's agents should do their work and offer them performance-based rewards and penalties, they can lower the risk of offshoring these processes.

Noncodifiable Processes.

Companies cannot easily codify the work because the variation in business events and employees' responses are too great to permit standard responses. Although it's often tough, companies may be able to evaluate the quality of execution. For instance, if employees don't fulfill orders correctly, customers will cancel those orders or return products. These processes are prone to a high degree of operational risk. If organizations do outsource them, they should closely supervise the service provider's agents. For example, in 2003, Ford Motor Company outsourced the task of handling supplier inquiries to India-based Allsec Technologies. Ford insisted that the Indian employees who handle those calls work under the supervision of Ford managers on the company's premises in Chennai. That allows the American giant to monitor the agents' work closely and to provide decision-making input in real time. Ford has compensated for the difficulty in codifying work by getting its managers to help the vendor's agents do that work.

Structural Risk.

Most companies don't worry about the behavior of service providers when they enter into contracts with them. They assume vendors will always act in ways that maximize both groups' interests. That isn't a wise assumption to make, even when companies are buying services from captive centers that they have set up. Like all supply chain partners, service providers can, and do, have incentives to behave in ways that reduce buyers' financial benefits from outsourcing. (For more on the role of incentives in supply chains, see V.G. Narayanan and Ananth Raman's article "Aligning Incentives in Supply Chains," HBR November 2004.)

> **Service providers can, and do, have incentives to behave in ways that reduce companies' financial benefits from outsourcing.**

Some structural risk arises because vendors can stop investing in training or employ people who aren't as qualified as the agents they presented during negotiations. Take the case of one Asian vendor that designs surveys, analyzes data, and develops customer profiles to help clients segment their markets better. When it signed contracts, the firm said that it would hire people only with postgraduate degrees in statistics or marketing and with four to six years of experience. However, as the firm's business grew, it began staffing projects with managers who had master's degrees, but not necessarily in statistics or marketing, and with less than two years of relevant experience. The quality of its services fell, but clients couldn't stop using the provider because they had reduced their own capabilities to a bare minimum. They had no choice but to bear the costs of training and upgrading the provider's agents until they came up to speed. Another problem is that service providers sometimes put in less effort than they initially agreed to. For instance, an offshore transactions processor hired by a large American bank agreed to check at random 12% of all the transactions it would process. The bank later found that, once its representatives stopped monitoring the provider, the provider checked only 5% of transactions. That reduced the provider's costs, but the bank had to absorb larger costs because of a rise in the number of undetected errors.

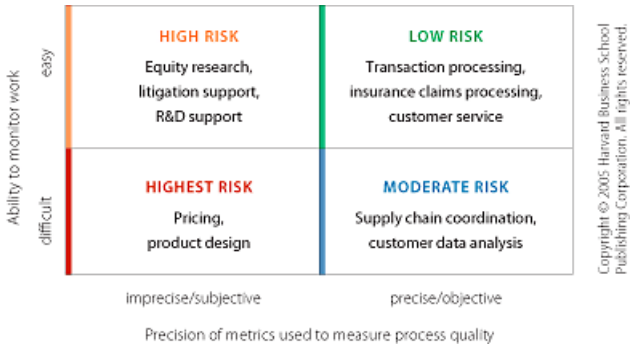
When companies supervise providers' work, structural risk falls. Thanks to advances in information technology, businesses can track providers' efforts in real time. In fact, most successful outsourcers monitor their agents as they're working, and the best service providers encourage this practice. Structural risk also falls when companies have metrics to gauge the quality of providers' work (see the exhibit "Evaluating Structural Risk").

Evaluating Structural Risk

To ascertain structural risk (the risk that relationships with service providers may not work as expected), companies should look at how precise their quality metrics are, as well as the extent to which the

Companies face another kind of structural risk when service providers alter the terms of contracts after clients have turned over processes to them. That happens because, as outsourcing contracts mature, the power in relationships shifts from the buyers to the sellers. Once companies have transferred processes to providers and terminated the

execution of processes can be monitered. Most processes fall into one of four categories.



services of employees who performed the tasks, they cannot bring those processes back into the organization on short notice. Knowing that, providers can demand exorbitant price increases when contracts come up for renewal. For instance, one vendor that archives, documents, and analyzes insurance claims raised its price by 65% when a contract came up for renewal. The client couldn't cancel the contract with the vendor because it had virtually eliminated its processing capacity. It reluctantly paid the vendor the new price for a year and later shifted all its business to another provider.

Two factors amplify these latent risks. First, when firms outsource processes that require the transfer of a large amount of tacit knowledge, they have to invest time and effort in training providers' employees. Second, some processes take a long time to stabilize when companies offshore them. In both cases, the cost of switching from existing providers is very high. That accentuates the risk that over time, vendors will dictate terms to buyers.

Buyers are never powerless, and they can hedge structural risks in several ways. When a firm negotiates a contract with a provider, it should specify a period after the contract's expiry during which the provider must continue to offer the service at a certain price. As a rule of thumb, the buffer should specify 150% of the time that it took the provider to deliver output that matched the company's quality standards. If it took 12 months for the vendor to come up to speed, the vendor must continue to provide the service for 18 months after the contract has expired. Lehman Brothers, for instance, has insisted on adding this clause to all its contracts with providers.

Although it may be difficult, companies should also split business between two providers. In the event a company wants to discontinue doing business with one of them, it can then transfer a process to the other vendor that is already executing the same process, however small the volumes may be. It will take the company less time to do that than to train a new provider from scratch. Having a second provider may also lower costs since the junior provider will bid low for contracts in exchange for greater volumes. That will put pressure on the senior provider. For example, Bank of America has developed relationships with two offshore providers of IT services. The vendors are comparable in many ways, and both realize that the bank can transfer work from one to the other if it wants to. When companies transfer complex processes, like equity research, cash-flow management, and forecasting, they should also retain some residual capacity so that they can bring processes back into the company if they have to. In the case of relatively vital processes, firms must retain enough in-house expertise to train new providers. Otherwise, businesses will have to ask incumbent providers to train potential rivals, which, in our experience, never works well.

Finally, companies face the risk that rivals may steal their intellectual property and proprietary processes if they transfer processes offshore, especially to emerging markets. There's no surefire way organizations can protect themselves against this risk unless they set up dedicated facilities offshore. Companies should decide they want to do that only after evaluating all their organizational options, and in the next section of this article, we will explore that process of evaluation.

Choose the Right Organizational Form

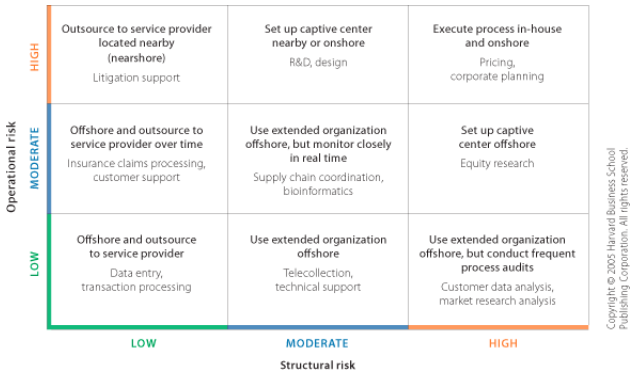
Most companies believe that they must either perform processes in-house or outsource them. That was true in the 1990s; today, however, companies can enter into joint ventures with other companies in the same industry or in other industries to generate services or, like GE, use the build-operate-transfer mechanism to create ventures that evolve from being part of the company into independent service providers.

Companies should match organizational structures to needs by considering both the structural and operational risks of offshoring processes. In general, they can use location—onshore, nearshore, or offshore—to combat operational risk, and organizational structures—such as captive centers and joint ventures—to respond to structural risk (see the exhibit "Choosing the Right Location and Organizational Form"). When both the operational and structural risks of offshoring processes are low, companies can outsource them to overseas service providers. As the operational risk of offshoring processes rises, locating them offshore becomes more dangerous. Companies should transfer processes that possess high levels of operational risk to nearby countries rather than to distant overseas locations. When the operational risk is very high, setting up captive centers locally is often the best solution. Outsourcing is less attractive in the case of processes with moderate or high structural risk; here, other forms of governance, such as joint ventures and captive centers, become better options. In the case of processes that have very high levels of structural risk, outsourcing isn't feasible. Companies must set up captive centers to execute those processes. Finally, when both operational and structural risks are very high, offshoring and outsourcing are out of the question. Companies must execute those processes onshore and in-house.

Choosing the Right Location and Organizational Form

Once a company has determined the operational and structural risks of outsourcing its processes, it can use this grid to choose the best locations and organizational forms for those tasks. The nine cells in this table show the optimal offshoring responses to different levels of risk.

When choosing organizational forms, companies have to trade off the control and quality they bring to the table with the scale economies and gains from the specialization that providers offer. Interestingly, offshoring has led to a hybrid form of organization that allows companies to, in a sense, have their cake and eat it, too. We call this structure the *extended organization*. In this hybrid organizational form, companies specify the quality of services they want and work closely alongside providers to get that quality. They manage providers carefully and monitor the agents' work to ensure that



things are done properly. Technology enables buyers and sellers of services to exchange information in real time and to embed themselves deeply in each other's companies. Firms can thus move away from command-and-control structures to sense-and-respond forms of collaboration.

Consider, by way of illustration, Chennai-based Office Tiger, which offers research support and real-time scenario analysis, and builds investment models for some leading investment banks in the United States and UK. The banks tolerate very few mistakes, so Office Tiger's employees can't learn through trial and error. Moreover, nearly a third of the company's deadlines must be met within an hour. To make the tie-ups work, the investment banks' managers and Office Tiger's executives jointly manage both long-term goals and day-to-day operations. Office Tiger has developed an information system, T-Track, to monitor the productivity and quality of groups of employees and, if required, the performance of each agent. Its clients use the system to ask for changes in agent assignments, to modify quality control mechanisms, and to alter project priorities. Crucially, Office Tiger's agents and the investment bankers they support work in tandem. Both can see, in real time, the models and scenarios their counterparts are creating. They work off the same files, the same spreadsheets and data feeds, and, when necessary, they work iteratively. Buyer and seller are separated by boundaries that are porous and constantly shifting; it's impossible to tell where one boundary ends and the other begins. Walk through Office Tiger's offices, and you will see how closely its agents work with clients. The provider has created different premises for each client, and agents working for one investment bank cannot enter the offices of agents working for another bank.

Similarly, Gecis—GE's erstwhile captive center and, in 2004, an independent $426 million service provider based in India—has created a version of the extended organization. Gecis (recently renamed Genpact) always configures project teams with two leaders, one of whom is an employee of the buyer's company. He or she, along with a Gecis manager, sets

priorities, tracks progress, helps define quality standards, and monitors the team. Every year, the two leaders jointly decide team members' pay, bonuses, and promotions. Gecis encourages its employees to see themselves as extensions of their clients. In fact, if you visit the floor in the Gecis center that executes several processes for a leading U.S. retail chain, you'll think you're in the retailer's own offices because of the decor and the vision statements on the walls.

Our studies suggest that the extended organization is the most effective way to manage offshoring. In a two-year study, we compared how a captive center, a provider, and an extended organization executed several moderately complex processes in the financial services sector. While the captive center produced the highest quality throughout the period of our study, the extended organization showed the greatest improvement and, over time, produced almost the same quality as the captive center. Moreover, the extended organization delivered that level of quality more cheaply than the captive center did. When we studied processes that were more complex, the same results held: The extended organization started out relatively poorly but, after it reached a stable state, was the most cost-effective way to execute processes. Clearly, offshoring isn't just about companies moving across geographical boundaries; it's also about companies redrawing organizational boundaries to achieve collaborative supply chains of information, expertise, and knowledge.• • •

It may sound like a cliché, but companies must treat offshoring as a strategic imperative if they wish to capture all its benefits. Offshoring initiatives that have cost savings as their raison d'être, our studies show, don't allow companies to capture greater revenues from the market. That's because such companies don't commit themselves to the organizational changes that are necessary for offshoring to help them, say, customize products or services, lock in buyers, compress new product-development cycles, or enhance profit margins. Besides, when offshoring is only about cutting costs, businesses are reluctant to outsource complex processes, even though doing so will have a bigger impact on their bottom lines. However, when corporations begin with the desire to create strategic

advantage through offshoring, they commit themselves to transferring complex processes relatively early. Companies would do well to remember that the manner in which they start their offshoring initiatives often determines how they will end.

1. “Alpha Corp.” is a pseudonym. For more details on the offshoring problems faced by this company, see Ravi Aron, Eric K. Clemons, and Sashi Reddi, “Just Right Outsourcing: Understanding and Managing Risk,” *Journal of Management Information Systems,* Fall 2005.

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