Business Research

Outsourcing Alternatives: Building a Subsidiary versus Contracting Virtual Teams

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Building a Subsidiary versus Contracting Virtual Teams

As more and more businesses are offshoring their non-core and, increasingly, core activities, the debate continues regarding the best working model for offshoring. The key question for businesses that have already made the decision to outsource is whether to set-up an offshore subsidiary or to contract virtual teams (third-party outsourcing). In this paper, we outline the benefits and disadvantages of these two offshoring models.

Virtual Teams

Access to large talent pools promotes International competition, improves quality and reduces cost. In the case of virtual teams, preformed teams with proven processes and procedures reduce risk and improve time-to-market.

Capital Investment

Setting up an offshore subsidiary involves investment in facilities, infrastructure (hardware, software, telecommunication, furniture, etc.) and human resources (both recruitment and training). These costs can be reduced to a large extent when outsourcing to a third-party vendor as their existing infrastructure and resources can be utilized.

Operational Costs

Third-party vendors operate at cost structures that are 10-20% lower than that of the offshore subsidiary[1]

In addition to low initial costs, leveraging virtual teams may also reduce operational costs. This occurs because third-party vendors have usually achieved economies of scale. According to the president and CFO of WNS Global Services, third-party vendors operate at cost structures that are 10-20% lower than that of an offshore subsidiary. These cost benefits are mainly derived from the following factors:

- Offshore subsidiary operations tend to pay higher salaries -- almost 20% more than third-party vendors -- in order to maintain their global brand name and attract the best professionals.
- Corporate overheads (IT, finance, HR, etc.) are also higher by approximately 30%, and cost of infrastructure by at least 10%.
  - Third-party vendors score better on negotiating facilities lease prices and logistics as they are well aware of, and have more leverage in, the local market scenario.
  - The overheads and infrastructure costs are distributed across multiple clients as third-party vendors work for several clients at the same time.

Effective Resource Utilization

("Buy only what you need" versus "build what you think you will need.")

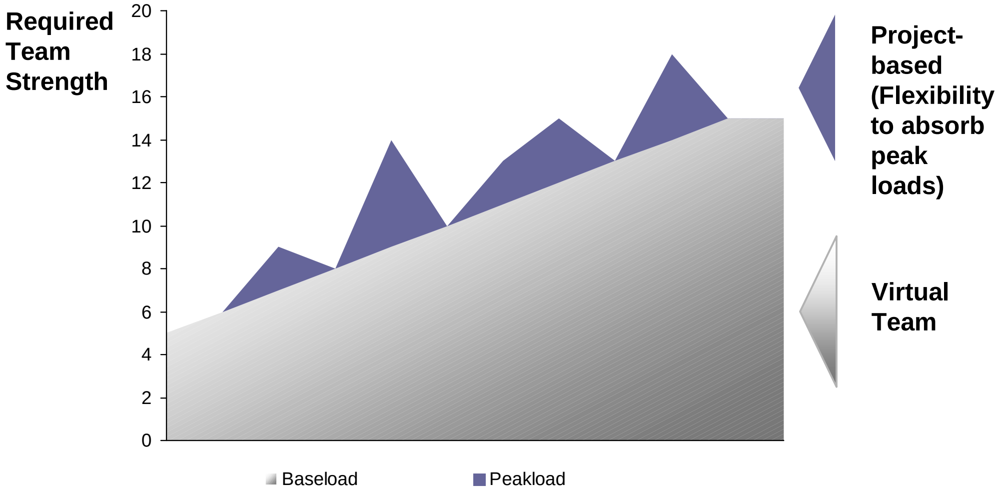
While virtual teams operate according to current outsourcing needs, the subsidiary has to be set up anticipating future needs. Moreover, by contracting virtual teams, a company can readily scale the number of resources required in accordance with demand. This helps them to successfully manage peak-load pressure while avoiding excess capacity. On the other hand, an offshore subsidiary needs to build teams and facilities in anticipation of future work.

[1] Source: http://economictimes.indiatimes.com/cms.dll/html/uncomp/articleshow?msid=52829

Figure 1 below illustrates the resource utilization by a third-party vendor in a base-load and peak-load situation.

Third-party vendors have the flexibility to absorb peak loads

Figure 1: Resource Utilization in Baseload and Peakload Situations by a Third-party Vendor



Source: Evalueserve

Reduced Risk

Contracting with virtual teams of a third party vendor reduces business risk in the following ways:

- By using preformed teams with proven processes and procedures
- By transferring large upfront fixed costs to incremental variable costs
- By using management teams with local experience and the expertise to manage and scale activities

Access to Specialized Skill-sets

Third-party vendors can provide the client with highly specialized skill-sets that can be matched to the unique requirement of the process/project. Moreover, the risk of obsolescence or additional investment in the event of changes in technology lies with the offshore partner rather than the offshoring business.

Reducing Management Complexity

Third-party vendors are able to significantly reduce the management overhead both during the start-up phase and steady-state operations. In the start-up phase, the management of the offshore subsidiary faces many challenges, such as setting up a legal entity, hiring and training people, and the transition of processes. Even if the company has local managers, the difficulties can be significant. During steady-state operations, management of the facility, ongoing training of employees, and the continuous transition of processes require significant management efforts. Conversely, the downside to offshoring business processes to third parties is that it may reduce the scope for further innovation and process improvement.

Reduced Time-to-market

Companies that set up an offshore subsidiary typically take at least 6 to 12 months to complete the cycle of establishing a legal entity, selecting a site, hiring and training professionals, etc.

Virtual teams can start almost immediate operations and processes can be transitioned in a very short time.

Moreover, problems stemming from inexperience can easily endanger the success of the whole operation. As compared to the offshore subsidiary, virtual teams can start operations almost immediately and processes can be transitioned in a very short period of time (from 2-3 weeks to 2-3 months, depending on the complexity of the process).

Offshore Subsidiaries

Maximum Control over Culture and Quality

Because the business is responsible for creating its own company culture, procedures and data security, it has maximum control over the offshore subsidiary including intellectual property. It may be easier to integrate the offshore subsidiary by transferring processes and procedures from its parent company. However, by doing this, the business may miss the opportunity to re-evaluate existing practices which may not be a good fit for the offshore subsidiary in terms of culture and process. Conversely, in many cases, utilizing a third party vendor offers an opportunity to adopt best-of-class practices across the enterprise.

Knowledge Transfer

Offshore subsidiaries face attrition levels as high as 35%, in the absence of devising new, more meaningful roles for their middle- and senior-level managers[2]

Both models demand continuous training of the employees. Offshore subsidiaries have an edge over the third-party vendor model, as it is relatively easy to provide training, and share and retain knowledge. However, the employees of an offshore subsidiary may not have the advantage of working on varied projects/assignments, which may limit the development of better skills-sets. An offshore subsidiary faces the risk of a high attrition rate, as they may not be able to devise new and more meaningful roles for their middle- and senior-level managers[2]. In certain locations, both models face the risk of an unstable workforce created by a greater demand than the supply of qualified people.

Mergers and Acquisitions

The offshore subsidiary and its intellectual capital are taken into account when valuing a parent company. This is particularly important when the parent company is being merged or acquired by other firms. In most of the valuation exercises, the number of engineers/technical professionals employed by the business is also considered. In such situation, an offshore subsidiary becomes an asset. Conversely, an offshore subsidiary may not be viewed as strategic by the acquiring company. Additionally, it can tie up capital in an undesirable or redundant location that may not be of interest to the acquiring company.

Reduced Dependence on the Third-party and Increased Dependence on Internal Resources

A business may prefer to set up its own subsidiary in order to avoid being dependent on third-party vendors. Many corporations have tried to reduce their dependency on these vendors by distributing the work/processes to more than one location or vendor. Distributing the work to more than one vendor encourages competition and enhances the quality of deliverables. In addition, it minimizes the risk associated with using a single third-party offshoring partner that could go out of business during the term of the contract.

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[2] The data represents attrition rates at GE and AmEx subsidiaries in India. Maximum attrition was observed in the middle and senior management levels. (Source: http://www.businessworldindia.com/oct2703/indepth05.asp)

Summary Table

The table below provides a comparison between virtual teams and offshore subsidiaries on various key parameters.

Table 1: Comparison between Virtual Teams and Offshore Subsidiaries on Key Parameters

	VIRTUAL TEAMS	OFFSHORE SUBSIDIARY
Initial investment and set –up costs	Low	High
Operational costs	Medium	High
Initial set-up time	Low	High
Operations ramp-up time	Low	High
Data security	Medium	High
Direct control over organisation culture and operations	Low	High
Direct control over internal processes	Medium	High
Management complexity	Medium	High
Access to specialized skill sets	High	Low
Valuation	Low	High
Protection of intellectual property	Medium	High
Direct exposure to external/macroeconomic factors	Medium	High

Source: Evalueserve

The Emerging Shift

There is no 'one model fit all' concept that ensures offshoring success. Developing the correct blend of available models for offshoring is the key challenge for most businesses. The following factors drive the selection of a particular model:

- The trade-off between the desired cost savings and the degree of operational risk that an offshore facility contributes to the business
- Degree of control and desired cultural alignment with the offshore facility
- Degree of flexibility and scalability required
- Required speed of execution