EXPERT insight

Illustration by EVA VÁZQUEZ

MORE THAN COST CUTTING

Adding Value Through Offshoring

By JOAN ENRIC RICART and PABLO AGNESE

The U.S. sitcom *Outsourced* is based on an all-too-real premise: An American manager named Todd suddenly finds his departmental functions being outsourced to a call center in Mumbai.

"Todd, we decided to restructure Order Fulfillment."

"Restructure how?"

"Offshore the whole department."

(Laughs.) "Good one."

"I'm not kidding. Check out this spreadsheet. Any American job that's done on the phone or online is going overseas. The savings are incredible."

"You can't outsource Order Fulfillment. Our catalog is patriotic knick-knack. If a factory worker from Wisconsin calls the 800 number to buy this and gets a person from another country, they'll flip out. You expect me to walk in there and tell everyone, 'I'm sorry, your job has been outsourced'?"

"I'll do it."

"So I'm fired, too?"

"No, not at all. We need you in India. Someone has to train the new guy."

"What does this new guy get paid?"

"Half a million... rupees. That's $11,000 a year to do your job. As in, eight for the price of one."

In real life as in fiction, the arguments made by numerous companies to offshore services in the '90s usually followed this same script. Those years saw offshoring as little more than simply moving call centers to countries with lower labor costs.

But things have changed. Today's new generation of offshoring increasingly features value-added services, such as highly complex software projects or specific R&D functions. Gone are the days of simple cost reduction, which favored the routine use of call centers and overseas software developers for minor projects.

Two of Spain's biggest banking groups, BBVA and Santander, exemplify the new and improved offshoring trend.

Less than a decade ago, BBVA was running its entire back office out of Madrid. Five years later, it had relocated these operations, first to the southern Spanish city of Malaga, before outsourcing two-thirds of its operations to low-cost destinations such as Buenos Aires, Mexico City and Lima. BBVA is currently doing the same with its remaining administrative activities in the other geographic areas where it operates.

Santander has taken a much more radical approach. Since 2000, the banking group has progressively transferred software development, computer centers and business operations to three subsidiaries. These, in turn, were given the freedom to concentrate, outsource or transfer part of those activities as they saw fit, but always under the supervision of the banks. At the same time, Santander has developed a single, shared technology platform and common processes, among which offshoring is just one facet of an overall operating strategy.

This article is based on studies conducted by the Offshoring Research Network, which is associated with IESE's Center for Globalization and Strategy. For companies interested in moving operations overseas, our research shows that offshoring has become a critical component of a business strategy aimed at creating value.

For those who have not yet made the leap, an understanding of the current state of offshoring is essential. First, we explain the factors that have contributed to transforming this business practice. Then, we weigh up the benefits and risks, before sharing some of the tools that will help you to define a successful international offshoring strategy suited to your organization.

EXECUTIVE SUMMARY

For decades, offshoring involved little more than moving call centers to countries with lower labor costs. But things have changed. Today's new generation of offshoring increasingly features value-added services, such as highly complex software projects or specific R&D functions. These changes are forcing companies to rethink their internationalization strategies in order to incorporate more of these kinds of value-added offshoring processes.

In this article, the authors discuss the risks and opportunities that managers must consider when offshoring, and they propose six steps aimed at creating value rather than simply reducing costs.

The IT Impetus

How did offshoring get to be so popular? Undoubtedly, the development of information technology, fuelled by the Internet, gave rise to a certain set of functions that could be relocated more easily, and influenced which business relationships could be maintained through offshore destinations.

Information and communications technology (ICT), such as Voice Over IP and telepresence, became not only much cheaper, but also, with the advent of more collaborative applications and cloud computing phenomena, more comprehensive. This enabled companies to carry out high value-added activities far from home with the maximum degree of reliability and efficiency. With digitization, distance ceased to be a problem and, in many ways, disappeared.

The Telemedicine Clinic is a good case in point. What began life in 2003 as a means to centralize diagnostic services performed by hospitals in Sweden has since expanded to become a full radiology solutions provider to where public hospitals across the European Union are able to subcontract their diagnostic services. A specialist based in Barcelona, for example, can have immediate access to X-rays taken in Sweden, and on-call specialists in Sydney make sure that quality readings are provided day or night.

Eventually, offshoring evolved beyond providing technical support services, to actually being a source of new professional expertise in the form of research and development. Such was the path taken by General Electric, IBM and Cisco. This went hand in hand with the proliferation of professional services firms and management consultancies, which specialized in offshoring and facilitated these tendencies even further.

From Cost Savings to Head-Hunting

In 2009, the Offshoring Research Network surveyed senior executives representing more than 2,000 companies and 4,300 offshore proj-

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ects in four continents. While these executives continued to cite "labor cost savings" as the top advantage of offshoring, the survey also turned up significant numbers of executives who valued, for instance, the benefits of access to qualified personnel or greater organizational flexibility (see **Exhibit 1**).

There are two main reasons behind this. First, many have come to the realization that "labor cost savings" cannot serve as the only source of competitive advantage, as there will always be someone who can do it cheaper.

Also, what's happening is that, thanks to better education, the supply of skilled labor in offshore destinations has improved significantly over the years. This means that these workers are able to take on and carry out new business tasks requiring high levels of knowledge.

Our research corroborates the development of talent and knowledge as a critical element in offshoring strategies – a development that reinforces the association of offshoring with value creation processes. As our analysis shows, improving the quality of skilled workers worldwide will encourage product development offshoring, as opposed to just offshoring lower value activities.

This shift has been partly driven by emerging countries making a firm commitment to invest in education and infrastructure. Several studies, including the one by the Offshoring Research Network, reveal explosive growth in the number of engineering and computer science graduates, especially in the two major offshoring destinations of India and China. No wonder the U.S. administration is concerned, as reflected by President Obama's pledge in 2010 for the United States to "produce eight million more college graduates by 2020, because America has to have the highest share of graduates compared to every other nation."

This growth in the availability of skilled labor has led to the emergence of clusters specialized in offshoring activities, like investment banks in Mumbai or call centers in Bangalore. The phenomenon is not restricted to the Asian giants. There are now IT-associated clusters in Latin America, too, from Guadalajara, Mexico, to Recife, Brazil, and Córdoba, Argentina.

Having clusters concentrated together in one area makes it easier for companies and universities to exchange ideas and people, with universities tending to become the main recruitment centers. Clusters can also generate pools of talent with specific capabilities, making these offshore destinations even more attractive.

But the picture is not entirely perfect. Some of these regions have suffered significant inflation as well as high turnover of labor.

Benefits Not Without Risks

The positive effects of offshoring on the productivity of companies and – by extension – the economy, are well-documented (see **"An Argument Blown Out of Proportion"**).

One study of 450 U.S. industries found that, between 1992 and 2000, offshoring succeeded in boosting productivity by as much as 10 per-

ABOUT THE AUTHORS

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