

The onshore-offshore dilemma

Outsourcing, or offshoring, has been the hot IT topic of the last decade. Whether the market grows or fades, however, depends on a complex mix of economic, client, staffing, attitude and cost issues.



Fiona Czerniawska

Like the internet, offshoring has had a slow-burning fuse. The IT industry in India, helped along by a combination of government protection and incentives, and a large pool of technical talent, began to attract attention ten years ago. Hardware and software companies led the way, with HP acquiring a 26 per cent stake in Hindustan Computers to create the then largest IT company in the world: HCLHP.

Since those pioneering days, the offshoring of IT services has enjoyed three phases of growth. The first two – Y2K and the internet – resulted from temporary shortages of skilled labour in the west. The current and perhaps more permanent phase has been driven by cost-cutting. Having travelled to India in search of skills, western corporations have stayed to take advantage of lower labour rates at a time when domestic IT budgets are depressed.

The slow-down in IT expenditure has not left the offshoring market untouched, however. The first generation of offshore suppliers is facing competition from even lower cost producers such as China. With rivals snapping at their heels, Indian firms are looking to climb higher up the value chain, using quality as a key differentiator in winning longer-term, more complex deals. But brand recognition, especially among the western companies now considering offshore alternatives, remains poor. ‘I want to make India and IT as synonymous as France and wine, or Switzerland and watches,’ says Kiran Karnik, president of India’s National Association of Software and Service Companies (NASSCOM).

There are challenges on the demand side too. Cultural issues, unrealistic service level expectations, transitional costs and the expense of ongoing relationship management mean that cautionary tales are now hitting the news stands. ‘There’s a lot of hype around offshoring, which means that no self-respecting CIO can afford not to have an offshore strategy,’ says Peter Hurley, vice-president, American Management Systems Europe. ‘But much less work is actually moving overseas than the hype would suggest: look at the numbers of people actually involved.’

Others believe that this is just the tip of the iceberg. ‘Offshoring has come from being a difficult decision, not so long ago, to a

standard for large organisations,’ says Tom Weakland, who leads DiamondCluster’s sourcing practice. ‘Virtually all of our clients are either thinking or doing IT outsourcing – and business process outsourcing is just the beginning of the curve.’ Srinjay Sengupta, head of Infosys in Europe, asserts: ‘Ten to 15 years ago, the kinds of services we offer now were simply not available. It’s only in the last few years that the global delivery model has really come together, and that’s what is driving this inexorable wave.’

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Onshore/offshore convergence

The last two years have seen offshore suppliers recruit sales and marketing staff in the western economies where their clients are located, and forge alliances with onshore firms that have established access to key markets. Now all the talk among these suppliers is of acquiring onshore staff who will give them their own business consulting skills and experienced client relationship managers. In a mirror image of this activity, onshore firms have hired offshoring experts and/or sought alliances with offshore service providers to shore up profits in the face of increasing price pressure. Onshore firms too are increasingly looking at acquisitions – of low-cost offshore facilities. But which will be easier: onshore suppliers shedding their legacy of high-cost code cutters, or offshore suppliers building exclusive client relationships?

Onshore suppliers’ problems centre on people: existing onshore staff levels, how to recruit and develop people in the future, and the willingness of senior managers to drive through necessary changes. For offshore companies, the critical issue is how to increase onshore presence without compromising overall cost advantage. ‘The high-cost [onshore] firms probably feel more comfortable,’ says Vikas Agrawal at Troika, ‘but how long will their advantage last? There’s only a limited window for them to change their cost structure and all

the time Indian firms can hire highly qualified consultants who've been laid off in the last two years.'

In essence, the challenge is one of scale. While offshore firms are looking to acquire only a small number of onshore people, the economics from an onshore perspective are daunting. 'Even among the top tier of global consulting firms, offshore resources make up only a tiny fraction of their entire workforce,' says Atul Vashistha, CEO of Neolt. 'But clients don't want 95:5 offshoring. Five thousand people in an Indian offshore development centre is nothing; five large clients could absorb all those resources easily. Such firms don't have a truly global sourcing approach, which is why offshore firms will continue to do well.'

'Onshore suppliers need to continue to change their entire delivery model,' asserts Duncan Aitchison, managing director of TPI International. 'And the pace at which they can execute this change will be determined by their culture and the commitment of their senior management. The technical issues involved pale into insignificance when compared with the ramifications of cutting across established organisational and profit structures.' At Booz Allen Hamilton, Kevin Gardner believes that a fundamental shift in attitude is required. 'Suppliers will have to move away from competing on the basis of skill sets to managing a portfolio of services,' he explains. 'Those that succeed will have a good mental model of the part of the supply chain where they do well, and can manage their own suppliers effectively.'

For offshore companies, timing is critical. 'There's a window of opportunity for us,' says Sudip Nandy, who is responsible for Wipro's European operations. 'In a year's time, there are likely to be three Indian firms earning over \$1bn in revenue. Unlike many of our onshore rivals, we have a genuinely global delivery model to offer our customers. We also have the capital to make acquisitions in several countries to enhance our presence.' But that window is already smaller than it was even a year ago. Although the Indian stock market has rallied since its March 2003 low, offshore firms may still not have the revenue multiple that allows them to acquire the desired size of company. 'They may end up buying smaller companies and try to make a virtue of this,' suggests Yatin Mahandru, a senior consultant at Fujitsu Consulting.

Capital will be less of an inhibitor than costs, however. Every time a low-cost firm adds an expensive high-cost individual to its workforce, it nudges up its cost base and, ultimately, its fees. 'We have to ensure that costs don't go up more quickly than revenue,' acknowledges Nandy.

Onshore and offshore firms find themselves caught between a rock and a hard place. While the pressures described are driving them inexorably towards acquisitions, the challenge of integrating

firms with different cultures and remuneration structures is a daunting one. 'Acquisitions have a terrible track record in the professional services sector, even when the firms involved have the same cultural heritage,' observes Sven Kielgas, chief marketing officer at Plaut. 'Think how much more difficult and cumbersome [the process] will be when repeated across a significant cultural divide.' Moreover, as Bob Scott, vice-president, global outsourcing services at CGE&Y points out, it is a Catch 22 situation: 'The chief barriers to integration are cultural: acquisitions work best when they're between culturally homogeneous firms. But, here, firms are making acquisitions because they want diversity; either they need people capable of building client relationships in different countries, or they want people with high-end business skills.'

The winners and losers

In fact, the questions raised by offshoring go far beyond simple onshore/offshore distinctions. What is at stake is how a consulting or IT services firm can balance, optimally and sustainably, high-cost selling and relationship management (onshore) with low-cost delivery and resources (offshore).

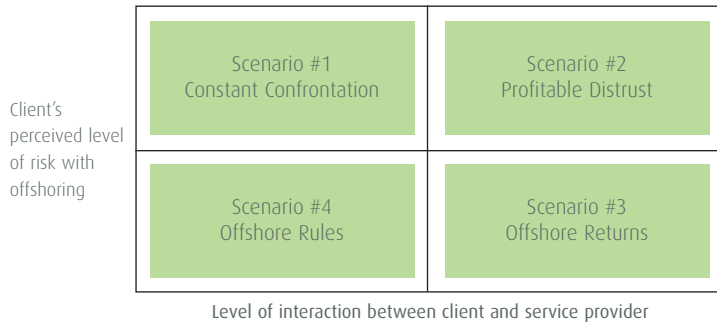
Unfortunately, there are two critical questions we cannot answer here. They are: to what extent will clients be prepared to sacrifice face-to-face contact with their suppliers in order to save costs? And how risky will companies perceive offshoring to be? Put these questions together and it is clear that we face four radically different scenarios. Future success will be determined by a firm's strategic resilience – that is, the extent to which its resources can be adapted to face the challenges of each scenario.

Scenario 1: Constant confrontation

While the market for offshoring has grown significantly and now extends to medium as well as large-scale organisations, trust has not. Reinforced by constant haggling over price, client-supplier relationships are at an all-time low. Clients have established their own procurement departments, staffed by outsourcing and offshoring experts who cultivate a confrontational style. Larger offshore suppliers have responded in kind, recruiting (or acquiring) their own class of aggressive, onshore account managers.

Succeeding in this scenario will require significant resources, both onshore and offshore. Suppliers will need locally based account managers and offshoring experts if they are to negotiate effectively with clients' own, in-house procurement teams. But they will only be able to secure contracts if they have sufficient offshore resources to keep the overall costs low.

Scale is the key. With price competition so intense, being able to achieve economies of scale will be an important source of competitive advantage. Onshore firms with a sizeable offshore



The risk-interaction relationship

presence will do well, as will the larger offshore firms that are already acquiring onshore account managers and building consulting teams. Most intermediaries (firms providing advice on how to offshore) will fare badly, squeezed out by a combination of direct negotiation between clients and suppliers with offshore facilities, and fierce price competition.

Scenario 2: Profitable distrust

Continuing concerns over the political and social stability of low-cost economies means that offshoring is seen as a high-risk strategy. Larger companies, still attracted by the cost differentials, manage the risk by relying heavily on the advice of independent intermediaries. The importance placed on independence means that those onshore suppliers that combined offering advice and brokering deals with their own offshore facilities have to choose between the two.

In contrast to the previous scenario, it is the intermediary firms that are likely to perform best in this environment, where clients choose to cushion themselves against the perceived risks by using third-party advisors, negotiators or even deal-makers. Also likely to benefit are the larger, better-branded offshore companies. Combining low costs with the security of comparatively well-known names, these firms will appear particularly attractive from the point of view of the intermediaries responsible for brokering the majority of offshoring deals.

Scenario 3: Onshore returns

A gradual upturn in the world economy post-2003 puts the brake on the seemingly inexorable expansion of offshoring. Clients turn increasingly to their more familiar, onshore suppliers to explore revenue-generating ideas. Thus demand for

outsourcing and offshoring has reached a plateau, while demand for traditional management consulting grows.

The main beneficiaries under this scenario will, without question, be conventional, onshore management consulting firms. Onshore IT services and consulting firms will also do well as clients look to buy higher end IT skills, rather than commodity body shopping.


Scenario 4: Offshore rules

A succession of stories in the press highlighting the proven advantages of offshoring and continuing budgetary pressure on clients result in an offshoring explosion. Offshore suppliers have grown rapidly. Increased access to clients has meant that many of the larger firms have succeeded in their aspirations to move up the value chain. Mounting revenues have allowed them to expand their onshore resource base without compromising their economic advantage. Some have acquired onshore suppliers to boost their immediate presence in local markets. Most have abandoned any pretence of working through third-party, onshore partners.

Access to offshore resources will be a critical determinant of success in this scenario. Not surprisingly, therefore, it is the largest offshore companies that stand to do best out of it and may even find themselves turning clients away (much as the fastest growing e-business consulting firms did in 1998-2000).

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Strategic resilience

If individual firms' performance varies across these different scenarios, which are likely to perform well across all of them? The low-risk, high-return firms fall into two groups: larger scale offshore companies and intermediaries specialising in complex deals. Most large-scale onshore firms fall into the high-return, though high-risk category, performing well in some scenarios, but badly in others. If you were a betting person, it is clear who you should put your money on. 

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