Offshoring to create value and compete for global talent
by Dr. Carine Peeters

Offshoring is the location of activities to a company, subsidiary, or independent service provider in another country (usually low cost), on a long-term basis, with the aim of importing the service to serve the company’s business back home.

Cost-reduction strategies are easy to imitate, and thus cannot be a source of sustained competitive advantage. Moreover, the rapid spread of offshoring is pushing up labour costs in developing countries, diminishing the returns from labour arbitrage. Because of this, in addition to taking out costs, companies should move towards offshoring strategies that create value and enable innovation and growth. In addition, developing economies are beginning to recognise the limits to labour arbitrage and are increasingly expanding their investments in human capital – especially engineering, mathematics and computer sciences – as a way of attracting higher level technical jobs.

Offshoring climbs the value chain
Companies have been offshoring for the past 50 years. For the first four of those decades it primarily affected manufacturing work and blue-collar jobs. There were two drivers behind the strategy of relocating manufacturing facilities. One was to take out costs by shifting manufacturing or assembly operations to low-wage countries, thus enabling firms from high-cost economies to align their cost structures with their global competitors. The other driver was the need to gain greater access to emerging markets by establishing a presence there. Since the late 1990s, companies have started offshoring business and IT processes.

Initially, this services offshoring was limited to highly-codified, transactional work such as credit card processing, claims administration, and call centre functions, as well as routine software development. In its second wave, the offshore work involved more technical judgment (e.g., finance and accounting, mortgage, and other back-office functions). Now companies are offshoring high-end work that has traditionally been considered “core” to the business, including chip design, financial and legal research, clinical trials, and book editing. As offshoring steadily makes its way up the value chain, it is not only encompassing higher-end white-collar work; it is fundamentally redefining the organisational structures and management practices.
of major corporations around the globe.

Although US companies were among the first to offshore IT and business process applications, the phenomenon is not restricted to the US. Over the past few years, a growing number of European companies have initiated offshoring strategies. Technology Partners International actually estimates that in 2004 the number of offshoring contracts by companies in Europe accounted for 48 per cent of all contracts (against 46 per cent for US companies). UK companies accounted for 20 per cent of the contracts and German companies for 12.5 per cent.

The Offshoring Research Network (ORN)

In response to the lack of rigorous and robust firm-level data on this emerging business practice, in 2004 the Center for International Business Education and Research (CIBER) at Duke University launched the Offshoring Research Network (ORN), a multi-year international study on offshoring. ORN’s overall objective is to track over several years the adoption of offshoring administrative and technical functions, from pioneering early adopters to the majority adopters. A survey research method is used to build a firm-level database on when companies started offshoring, what particular business function is involved, where it was offshored, what service delivery model is used and why. Detailed data is also collected on various aspects of firm experience with offshoring – including perceived risks, expected and achieved benefits, and future plans.

Since 2006, the project has been expanded to include partners in several European countries (Germany, United Kingdom, the Netherlands, Spain, Scandinavia, and Belgium through ULB-Solvay Business School). The ORN study targets both SMEs and large companies, be they currently offshoring, considering offshoring in the future, or not planning to start offshoring. In addition to quantitative analyses of the survey data, ORN also conducts company case studies and organises closed debriefing meetings for survey participants following the administration of the survey. The data and insight provided in this article come from the first three US surveys, together with associated case studies and interviews with senior managers in offshoring companies.

Why, what and where to offshore?

Why? While cost reduction remains a prime justification for many offshoring implementations, labour arbitrage is no longer the only impetus (Figure 1).

Beyond cost motives, companies report that their offshoring decisions are driven by the possibility of accessing qualified personnel, and by business growth objectives, as well as by a desire to improve the efficiency and service levels of their processes and to increase the speed to market of their products.

Low-cost skilled human resources actually enable companies to offer a range of people-intensive services that are not economically feasible in high-cost economies such as the US or Western Europe, but which improve the value proposition for their customers. For example, Offshoring allows companies to offer unique services highly valued by customers – such as 24/7 customer support. Offshoring also enables companies to grow their resources economically and thus speed the product development process and alleviate constraints that might otherwise hold back their business growth.

What? Twenty years ago, anyone who advocated locating core engineering jobs in a developing nation would have been greeted with derision. Not only were engineers in developing countries considered less competent, they also did not have access to the state-of-the-art computing and telecommunications infrastructure that these jobs demand. Further, the sharing of blueprints and data was a time-consuming, risky, and expensive enterprise. But today, more and more companies – instead of limiting their offshoring strategy to traditional IT, call centres or accounting services – are also looking at offshoring technical and scientific activities such as R&D and engineering services (Figure 2).

Indeed, companies are increasingly offshoring to gain critical access to highly skilled scientific and engineering talent in China, India, Eastern Europe, and other emerging locations. One example is IBM, which has already established an R&D lab in New Delhi and announced its intention to recruit 14,000 additional software engineers in India. Another is Motorola, whose 16 separate R&D centres in China collectively employ 1,800 engineers, which is 10 percent of the company’s global R&D head count. A third example is Timken, which opened its second biggest R&D centre in the world in India. In addition, General Motors founded an automotive research lab and Intel opened a development centre in India, while the Jack Welch Technology Center, the first and largest General Electric R&D centre launched outside the US, is in Bangalore.
Interestingly, this offshoring of work with a high-technical skill content does not result in job losses in the originating country; rather the overall job pool is increasing. In fact, no domestic jobs were lost in three out of every four offshoring projects surveyed that involved R&D, product design, or engineering work. In contrast, offshoring of routine back-office functions does result in lost jobs approximately half the time.

The reason is that offshoring of innovation, engineering, and product development functions (including software development) is an integral element of corporate growth plans. So companies are less motivated by labour arbitrage opportunity (i.e., replacing existing jobs in the high-wage home country) than they are by the need to fill critical talent gaps. This finding has to be seen in the context of a growing shortage of trained scientists and engineers. In the US, the number of residents (including immigrants with green cards) graduating with master’s and Ph.D. degrees in engineering has steadily declined over the past few years. Meanwhile, the demand for science and engineering graduates has been growing, creating a widening gap in the supply of engineering talent. The impact of this supply gap had been masked for some time by a growing quota of H1B immigrant work visas that allowed foreign engineers and scientists to be imported. However, since the annual H1B visa cap was slashed in 2004 from 195,000 to 65,000, this onshore supply problem has been revealed, and employers may now be forced to hunt for talent offshore. In Europe, although absolute numbers of math, science and technology graduates have increased recently, the overall share of graduates in these fields continues to fall. As a result, several companies in high-tech fields are already complaining about the difficulty of finding the human resources they need to support their growth objectives.

Where? Thanks to its large pool of English-speaking qualified workers, India was the first emerging economy to build a reputation as a good offshore location for services activities. Today, it still remains the favorite location for offshore projects originating from companies in the US (Figure 3). China, which is often considered as “the factory of the world”, is trying to catch up and attract more high-end services jobs. But its smaller size naturally constrains the growth of the Philippines as a major offshore location. The Philippines is emerging as a close competitor to India for contact centres and administrative capabilities, although its poor English skills and significantly lower expertise in IT.

The two most important reasons why companies select specific countries for offshoring are the cost of labour and the availability of well-trained workers.

Factors related to Government policy – such as the quality of infrastructure, political stability and other government incentives – are increasingly persuasive in selecting offshore sites, so the competitive playing field is far from static.

When plotting offshoring locations against these two reasons, India rates highest on the combined availability of talent and low cost of labour.

However, where you offshore also depends on what you offshore. For instance, thanks to its good English skills and customer-oriented culture, the Philippines is emerging as a close competitor to India for contact centres and administrative capabilities, although its competitiveness is considered lower than India.

The competitive playing field is far from static, because factors related to government policy, such as the quality of infrastructure, political stability and other government incentives, are increasingly persuasive in selecting offshore sites. Actually, governments in many prospective offshore destinations have made attracting this business a
In Europe, the share of offshore projects going to Eastern European countries is significantly higher than for companies in the US. Some companies in Europe actually see Eastern Europe as a "nearshoring" strategy that allows them to mitigate certain risks associated with the challenge of managing far-distant business processes. Further, European language skills—such as fluency in German—may be easier to find in Eastern Europe than in India or China. For the same reason we also see Northern African countries such as Morocco or Tunisia investing in attracting offshore projects from French-speaking companies.

Not without risk
Concerns about achieving the desired service quality and the ability to assure data security are cited as the most important perceived risks by companies participating in the ORN study. But organisational constraints such as "operational efficiency", "loss of managerial control" and "lack of acceptance among internal clients" are also emerging as hot-button issues. Interestingly, it seems that companies are reluctant to offshore not because there is anything inherently unworkable or difficult about the arrangement or service provider, but rather because they don't think their own organisation can handle it. That is a cause for concern and a call to action—particularly since many of these issues are controllable through careful planning, continuing adjustment, and effective execution.

Other challenges that offshoring companies have to deal with include high employee turnover at offshore locations, third-shift low performance issues, and the risk of losing critical process knowledge. Overcoming these difficulties calls for specific strategies and management practices that go beyond replicating what competitors have successfully done in the past and what companies are used to doing at home. For instance, it may be a better strategy to investigate 2nd tier cities with good potential for development than to focus on offshoring hot spots. While these have already proved their capacities, they are also likely to suffer from high wage inflation and employee turnover as foreign investments continue to pour into the same, already crowded areas. The problem of lower quality of service associated with employees working at night might also be alleviated by innovative HRM practices that allow these employees to work temporarily on specific projects during the day. Other important elements in overcoming the turnover and performance issues include investing in team building and creating career development paths for all offshore workers.

A strategy of value creation
So far, the big majority of companies have focused on realising the immediate benefits of labour arbitrage in low-cost countries. However, these benefits are being eroded by rapid wage inflation (up 26% in Bangalore in 2006) and high employee-turnover rates— with the associated costs and declining service levels. Only a few companies have recognised that they must begin to create longer term competitive advantages through greater efficiencies and fundamentally transformed business processes on a global scale. In other words, companies should evolve from a purely cost-focused offshoring strategy to a strategy of differentiation and value creation (Figure 4).

Whether at business unit or corporate level, an offshoring strategy can be seen as four main pillars that companies
significant process reengineering. The companies should tap into, and partner with to implement and benefit from activities that offshoring can start to rethink the way they operate, and look at how offshoring could help them improve through the reengineering of certain processes. Offshore service providers may play a key role in that context. Service providers build their expertise by undertaking similar or related activities for different clients. If invited to the table, they may be a very good source of suggestions that offshoring companies should tap into, and partner with to implement and benefit from significant process reengineering. The last stage of the company’s learning process is a profound rethinking of the way it sees offshoring: looking beyond a means to do things more cheaply, on a larger scale, or better, to see it as a means to do new things and create new value for the company.

This involves leveraging offshoring to develop new knowledge and capabilities, to experiment with new business models and to develop new product and service offerings that were previously unimaginable. For instance, a global electronics company that the ORN studied developed a new capability in on-line product design, thanks to a team of engineers in the Philippines who interact in real time with clients from around the world. After leveraging this capability to offer a new service of on-line closet design for end-users, they are looking into adapting the system to the design of motors customised to the particular environment of their various industrial clients, using engineers in China or India.

But developing an offshoring strategy that creates value does not necessarily mean abandoning the benefits of one stage, or pillar, to move to the next one. At any given time, different processes will be at different stages. Indeed, for certain tasks, it may not make sense to move beyond labour arbitrage, and some of the remaining advantages. For other activities, such as product design, it may be that labour cost will not be an issue, and the objective will instead be to redesign the process so as to allow a major drop in the time to market new products. In the same way that companies revise their corporate strategic planning, defining an offshoring strategy means to do things more cheaply, on a larger scale, or better, to see it as a means to do new things and create new value for the company.

**Figure 4 Elements of an offshoring strategy**

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<th>Labour Arbitrage</th>
<th>Scale</th>
<th>Process reengineering</th>
<th>Value creation</th>
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Global access to talent

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strategy is a dynamic process that requires periodic revision. A new source of value creation today may indeed become a standard offering that requires a high focus on cost containment within a few months or years. It should also be stressed that evolving towards more value-creation objectives requires companies to access increasingly qualified offshore personnel anywhere in the world.

Getting the full benefit

As we have seen, offshoring can be understood as the fractioning of value chains on a global basis. In other words, offshoring provides the opportunity for companies to perform each of their business activities where it makes the most sense economically and strategically. No longer does the employee move to the job; the job moves to him in Bangalore or Beijing or Budapest. This new way of doing business calls for new skills and capabilities that companies need to develop. These include change management; remote management; flexibility of working across time zones, styles, and cultures; and efficient use of ICTs.

Managers have to adapt their practices and beliefs to work effectively with employees who may be 10 time zones away, rather than expecting employees to adapt themselves to a far-away manager’s style or the organisation’s long-standing culture. As significant organisations are built offshore, objectives such as global collaboration between disparate workforces, efficient information flows, properly delegated decision rights and appropriate incentives, will rise in importance. Management and organisational practices will necessarily need to adapt to address these priorities.

Regarding the organisation of offshore activities, companies must balance the pros and cons of different service delivery models: captive subsidiary, joint venture, arms-length outsourcing arrangements with independent vendors, or some hybrid of these. If companies choose an offshore outsourcing type of model, they will need to adapt their vendor selection criteria to identify vendors that are capable of process reengineering and value creation, as opposed to just reducing costs. But although finding the best provider is crucial, it is not all. The road towards creating business value through offshoring is a two-way street, so companies should consider their vendors as real partners, and not as mere counterparts in traditional buyer-supplier one-way relationships.

Finally, although human capital used to be geographically bounded, now, it’s global. As a result, the ability to source, develop, and manage talent on a global basis may well turn out to be a key competitive differentiator in years to come. This means being able to locate, source, train, coordinate and retain talent anywhere in the world. It combines the capacity to see the global big picture with the ability to translate it into action in each individual labour market — and to do it over and over again as circumstances change. This requires likely trends in wage rates and availability of talent over the medium and long term to be taken into account.

But that’s not all. A country’s labour rates must be weighed against the skills, productivity, and education levels of its workforce, the transportation and telecommunications infrastructure of its cities, and the receptivity and stability of its government — all of which influence relative competitiveness. Moreover, global workforce planning must be tightly integrated with the corporate strategic planning cycle. Senior management needs to identify the capabilities required for the offshoring strategy to succeed, and then translate those capabilities into organisational requirements (such as skill sets, knowledge, competitive pay structures, and location). Companies should focus attention on forecasting and quantifying their workforce requirements so that they can make informed decisions about workforce footprint. While the linking of corporate strategy and global workforce planning may seem self-evident, it is surprising how many companies have neglected it so far.

From a public policy perspective, in today’s global economy, it’s all the more important for nations to invest in the education, training, and employment of their people. This is not just a social imperative, it is also an economic one. And these educational investments and incentives should be focused on the skills or links in the value chain where a nation’s workforce can achieve the greatest impact.

FURTHER READING