RESEARCH SUMMARY:
Onshore Versus Offshore Outsourcing: Significant differences require unique approaches
By neoIT

Outsourcing IT services and business functions is becoming an increasingly common global practice among enterprises looking for competitive advantage. The guiding principle being that non-core and even critical activities of an enterprise could be handed over to companies with expertise in those activities, thereby freeing internal resources to focus on enhancing the value-add of its core business. Over the last decade, the use of offshore resources to support this trend has significantly changed the landscape for outsourcing. Today, Offshore Outsourcing accounts for nearly 10% of the $536 billion Global IT services and BPO industry¹. However, there are some fundamental differences between the traditional onshore outsourcing models and the global delivery model (offshore outsourcing), that significantly impacts planning, sourcing, and management of effective offshore operations.

Key issue: What are the key differences that enterprises should be aware of when comparing the traditional onshore outsourcing and the offshore outsourcing model? In the sourcing life cycle, what are the differences in methodology that ensure a successful engagement in offshore outsourcing? Why do the same approaches not work for both onshore and offshore outsourcing?

¹Worldwide IT Services Market Forecast 2002-2007, Gartner Research.
Introduction

The guiding principle of outsourcing has been the transfer of a process or function, that is typically not a core competence of an enterprise, to an organization that has expertise in that area, allowing the enterprise to effectively utilize its resources in its core areas of business.

This principle has dual objectives:

- Save on cost of operation by acquiring services from a team more productive that the internal resources (based on their expertise, or their ability to leverage infrastructure across multiple clients); and

- Improve quality and value of operation by acquiring services from an organization with best practices in managing that business activity.

Any outsourcing contract will ultimately be about either or both of these two objectives.

In an onshore outsourcing initiative, since the cost basis between internal and external operations is similar, achieving either objective requires the outsourcer have one of the following capabilities.

- A common IT infrastructure that supports the business function being outsourced, such that it is leveragable across multiple clients, thereby reducing the per client cost of operation. (e.g. the ADP model for outsourcing payroll, or datacenter outsourcing to IBM). This model, however, necessitates standardization of processes to be outsourced,

- Very specific process or domain expertise that allows the outsourcer to be significantly more efficient and productive (e.g. marketing departments outsourcing creative to advertising agencies,), or

- Operational superiority, that allows the quality and value of the service delivered to greatly exceed any internal benchmarks (e.g. Transformational outsourcing services from the likes of Accenture and IBM, or outsourcing auto claims processing to CGI).

In the absence of any of these characteristics, outsourcing can only be more expensive and less valuable than an internal operation. Furthermore, making improvements in existing processes, whether incremental or transformational, creates process stress that can be risky for the enterprise. Since each of these characteristics require large investments in time and resources, it is not surprising that, over the last two years, many seemingly well-structured outsourcing deals have failed to meet expectations.

When considered at a high level, offshore sourcing appears to be just another delivery model for outsourcing service - and in the years to come, as the global delivery model becomes ubiquitous, it may well become so. Today, however, it is anything but. Offshore outsourcing, by focusing on changing the cost basis of operations, essentially alters the structure of the outsourcing industry and makes it easier to cost-effectively outsource non-core and even critical business functions. Easier, at least, in the sense of generating savings and value, though, in several other ways, offshore outsourcing is very complex and difficult to plan and manage. This leads to some key differences, most importantly in the sourcing lifecycle. These differences are largely due to the differing operating models, financial models and risk profiles.
Differences in Sourcing

Whereas domestic service provisioning is typically assessed on the basis of infrastructure leverage, domain expertise or process knowledge, offshore service provisioning is primarily assessed on the cost basis for consistent quality of service, and capacity to leverage global resources.

Though parallel between the onshore and offshore outsourcing lifecycle are evident, enterprises could make serious mistakes if they use the same sourcing strategy for offshore that they’ve used for domestic sourcing.

Some of the significant differences in the sourcing strategy include:

- **Insourcing vs. Outsourcing** – Managing the complexities of the global delivery model requires a deep expertise in the local environments and experience with cross-border business operation, making the evaluation of whether to outsource a project or leave it in-house very different from a purely onshore sourcing decision.

- **Structure of the solution** – The lack of maturity of the offshore industry requires a significant commitment from the enterprise in supporting the development and growth of the outsourcing solution. Making that commitment, keeping a eye on the long-view necessitates a strategic sourcing decision, distinctly different from a domestic sourcing contract.

- **Due diligence on operating models and supplier selection** – The level of due diligence required, and the types of issues to address during supplier selection are substantially different. For example, in offshore sourcing for 24X7 process support, it is imperative to check the availability of 100% captive power generation. Indeed, it’s imperative to check for the level of reserve gasoline available.

- **Resource deployment/redeployment** – Offshore Outsourcing transactions rarely include asset and resource transfers from the buyer to the service provider, whereas in onshore sourcing deals, that is a common point of negotiation.

- **Knowledge transfer** – the transfer of information and training around the buyer’s IT environment and other relationship parameters are very difficult to do in offshore sourcing. Since this has a direct effect on path to productivity for service providers, it becomes an important evaluation criterion, as well as a phase in the sourcing cycle.

- **Portfolio Assessment and planning** – the ‘offshoreability’ of an IT service or business process is dependent on many factors, and in most enterprises, transitioning to an offshore model requires early planning. The portfolio assessment and planning phase is a critical component of a successful offshore sourcing initiative.

In the ‘Recommendations’ section below there is a discussion on specific distinctions made in each phase of the sourcing lifecycle for an offshore sourcing Initiative. If a company can focus on managing the differences in the lifecycle, they can dramatically shift the probability of success to their favor.

The differences in the sourcing cycle are a result of differences in operating model, financial model and risk profiles between onshore and offshore sourcing.
Differences in the Operating Model and Capabilities

In order to understand the operation and capability of the offshore market, it is important to understand its evolution.

Within the onshore outsourcing industry, IT and business process outsourcing has largely evolved across a continuum of expanding service value, and integration across service lines. Accenture, today one of the leading IT outsourcers, started within an audit firm, and then progressively expanded to provide consulting on business planning, strategy and process improvements. IBM Global Services, Accenture, CSC and EDS started primarily as technologists, and progressively acquired process and domain strength to become full-service outsourcers. The investment among these organizations has been on acquiring industry and process knowledge.

On the other hand, over the space of 15 years most offshore service providers have evolved primary along an operating continuum, from the on-site use of temporary foreign labor, to large offshore development centers. The investment, in this case, has clearly been on developing the underlying infrastructure to manage the complexity of cross-border service delivery. Infrastructure has several components – telecommunications; service delivery architecture; methodology for managing characteristics adverse to collaboration and team building; and process and service delivery standards that ensure quality.

It is this difference in focus of investment and evolution of operating capability that still leads most enterprises to a dichotomy in decision-making. Is the primary purpose of the outsourcing initiative cost optimization and global sourcing, or is it acquiring specific business expertise? The short list of potential service providers, and the overall sourcing strategy differs widely based on the answer to that question.

Over the last couple of years, as enterprises increasingly focused on leveraging the global delivery model for their IT and business process needs, onshore service providers have started to make significant investments in the infrastructure for offshore sourcing.

Differences in the Financial Model

One of the most significant differences between onshore and offshore outsourcing is apparent in the financial model. Since offshore sourcing is fundamentally about changing the cost basis of operations, the models need to be substantially different. It is important to understand the particular characteristics of offshore sourcing and the associated costs when determining both the cost lines in the model, as well as the assumptions of allocated costs.

For instance, the wage rates in India, Philippines or China, for programming resources are ~70% less than the wage rates in the United States, still on average the cost savings in offshore Application Management relationships are typically about 40%. More curiously, on a “total cost of offshoring” basis, offshore locations with higher wage rates can sometimes actually be more cost effective overall.

This is because the additional costs of offshoring can dramatically change the equation. For example communication infrastructure, effort in knowledge transfer, development of redundant systems, inefficiency in resource redeployment, need for on-going monitoring, etc. will be very different based on the region of supply and services delivered.
Differences in Risk Profiles

There are several risk parameters for an enterprise looking to outsource an IT or business function. Some of these are common between onshore and offshore outsourcing (possibly exacerbated by the offshore operating model), while others are unique to the delivery of services across borders.

Listed below are some of the potential risks that need to be managed in an offshore outsourcing relationship:

- **Internal Readiness** – Is the enterprise ready for an offshore outsourcing initiative? In order to ensure readiness, there are certain steps that need to be taken that include developing communication plans, getting senior executive sponsorship, assessing the portfolio of technologies and processes, preparing for remote management, training for cultural differences, etc.

- **Geopolitical Risk** – How can companies achieve cost reductions and take advantage of skilled, offshore resources while minimizing the risk of operating in an offshore location? A geopolitical examination can help provide answers to these questions. e.g., border unrest, religious strife, political processes, government policies (taxes, duties, regulatory hurdles), and relations between countries, war, and terrorism.

- **Socioeconomic Risks** – Are the shareholders and the local community willing to accept the significant socio-economic gaps or will they see this as job loss to a lower cost sweatshop?

- **Country Factors** – Which locations offer lower risk? Should more than one location be considered for performing the work? A country comparison will provide insight into the risks that the company is willing to take on and others that they may need to prepare for. e.g., economic, political, infrastructure, legal, etc.

- **Vendor Landscape** – Many offshore vendors lack maturity and focus and there is a great disparity in quality and processes. Offshore vendors are less likely than their domestic competition to have domain expertise, industry-specific expertise and the ability to support multiple applications and/or business processes. The number of suppliers (and locations) in the market also adds to the difficulty in evaluating vendors.

- **Cultural Differences** – Cultural differences need to be managed on both sides of the ocean. How should companies go through the learning curve as they adjust to working with offshore partners? Should they enlist advisors or suppliers to help them in the process? Are other organizations sources of assistance?

- **Legal/Contractual** – How can companies ensure that key industry regulations and standards are designed into the offshore solution? How can companies monitor and manage offshore compliance?

- **Knowledge Transfer** – What is the best way to manage the transitioning of knowledge and key resources? Should a phased strategy be used to mitigate risk and manage productivity?

- **Change Management** – Offshore deals require significant change management within the enterprise. How can companies effectively communicate and work with impacted employees in understanding and supporting the use of offshore resources? How should personnel and issues be managed to minimize the potential for disruption?
The Differences in Onshore and Offshore Outsourcing

- **BCP/DRP** – How can companies ensure they maintain flexibility and responsiveness in meeting customer demand? How do they maintain data security? What steps need to be taken to formalize offshore security and data privacy plans that comply with International standards like ISO17799 / BS7799, CoBIT, Safe Harbor etc.?

- **Pricing** – How should companies manage currency and project scope risk? Should companies choose fixed pricing or time and materials? What are the key factors to include in order to arrive at fixed pricing? What about renegotiating ability?

- **Treasury** – For long-term offshore engagement, treasury issues can be either a competitive advantage or a risk to the financial viability of the model. Companies need to build exchange rate fluctuations, inflation rates, interest rates and other treasury issues into their financial models.

- **Exit Planning** – What happens if the offshore engagement does not work? What happens next? Companies need to invest time in building an exit plan to include answers to questions beyond IP issues. Spend time thinking about financial models for exit, knowledge and/or resource transition plans, timing, who is involved, etc.

### Recommendations

**A Best Practices Approach to Managing the Differences**

These unique characteristics of the global delivery model lead to the need for a sourcing methodology different for offshore outsourcing than for onshore outsourcing relationships. More critically, it requires a fundamentally different governance model. Segmented into four phases, Knowledge, Plan, Source and Manage\(^1\), this systematic method encompasses the entire sourcing lifecycle from planning to services management and receipt. This best practices approach to offshoring ensures companies’ success by addressing the risks companies face as they modify their sourcing strategies to include both onshore and offshore techniques.

**Knowledge:** In the Knowledge phase of the offshoring lifecycle companies gain a higher understanding of offshore practices, methodologies, experiences, returns and risks. Very often enterprises appear to rush into a global sourcing relationship, frequently under pressure to reduce costs or gain competitive advantage. Stop. Hasty decisions in offshore sourcing will lead to mismanaged projects and unmet expectations. Realize that offshoring will add multiple dimensions to a typical outsourcing deal.

- **Take time to research and understand the market.** Understanding the offshore landscape is much more complex than gaining insight into the domestic market. There are many additional factors to understand and evaluate and credible information sources may be more difficult to come by. In offshore outsourcing, companies are burdened with the need to understand additional risk factors, multiple countries, diverse and fragmented supplier markets, and global financial models. It is highly recommended that the buyer take a tour of the top 3-4 offshore destinations in order to become familiar with the offshore world.

- **Conduct a thorough analysis of ownership options** (Offshore/Nearshore; Outsourcing/BOT/JV/Insourcing; Application/Process/Infrastructure, Domestic suppliers/Offshore suppliers, etc.).

---

1 The O4 Methodology (Knowledge, Plan, Source, Manage) is the intellectual property of neoIT
The Differences in Onshore and Offshore Outsourcing

- **Be cognizant of the added costs** due to infrastructure, communication, project management, retrenchment, risk management and program management.

**Plan:** In the Plan phase companies look at their portfolio of applications and business processes and build a roadmap that will guide them on their offshore journey. Once the decision is made that an outsourcing strategy is viable, in both offshore or onshore deals, the next step is to perform a thorough evaluation and develop a roadmap for the journey. As companies develop these plans, offshore outsourcing differs from an onshore engagement because of the questions that are asked (what, where, when, how), the criteria that are evaluated and the models that are used to build the final map.

- **Understand the characteristics of the offshore operating model** - As enterprises continue to outsource offshore, they must evaluate their weight and importance on four key factors:
  - Cost savings
  - Level of Control
  - Service Quality
  - Risk Tolerance

The relative importance of each of these four factors will drive the sourcing decisions. For example, clients (or projects) with low risk tolerance tend to choose mainstream offshore locations or choose lower risk nearshore and domestic suppliers. However, a client with a higher risk tolerance will tend to pick offshore suppliers of varied sizes and expertise to achieve higher cost and quality goals. Regardless of the choice, it is critical that the buyer understands the complexities in an offshore sourcing initiative, and spends time and effort researching and understanding the attributes of the factors mentioned above.

- **Analyze the ‘Total Cost of Offshoring’** – It is important to understand the particular characteristics of offshore sourcing and the associated costs when determining both the cost lines in the model, as well as the assumptions of allocated costs.

**Source:** In the Source phase firms carefully study their IT and business processes and evaluate risks to make decisions on ownership models. As companies move through the sourcing process from ownership decisions through to signing the final deal, the differences in offshore and onshore engagement abound. In offshore outsourcing, companies need to pay particular attention to risk mitigation, due diligence, pricing models and contracting.

- **Carefully determine the operating model** – Choice of models, whether outsourced, in-house, Joint Ventures or Build-Operate-Transfer each has a certain set of advantages and risks. The portfolio assessment phase and the financial analysis will help determine the right balance of cost, control and quality.

- **Develop credible risk mitigation** - It is very important not to leave too much to chance in offshore deals. The long-term success of the initiative is directly related to the level of planning for risk, and the commensurate governance structure set in place. Having a well-considered risk management document that measures the probability (or frequency) of each type of risk and the impact on the enterprise will be critical in determining the ultimately success of the offshore initiative. The risk management framework will also define which risks need to be managed, which can be transferred, and which can be simply ignored.

- **Conduct due diligence beyond process maturity** – As stated earlier, offshore markets and suppliers lack depth of experience and process maturity. Site visits as
part of the due diligence process are invaluable to determine core expertise and performance capabilities mapping beyond process maturity. Third-party validation can also be helpful to further reduce risks.

- **Develop a scale-up and exit plan** – It is critical to have a strong and well-defined scale-up and exit plans in place - as enterprises continue to migrate increasing amounts of work offshore, there is a strong incentive to using the incumbent offshore service provider, leaving the enterprise over-exposed to specific offshore companies. By planning ahead, companies allow for flexible, quick adjustments.

- **Contract for flexibility and delivery assurance** – Country and supplier specific knowledge is very critical here. Involve local counsel and ask the right questions: will this contract give the employees of the outsourcing country the right to claim they are employees?, legal activities?, protect IP rights? Understand the legal framework – structure the contract for ongoing long term managed success and not just enforceability. Remain ready for disaster and ensure that contingency plans for business continuity are in place.

**Manage:** The Manage phase deals with transitioning the supplier relationship or the build phase from negotiations/research to service execution. Monitoring and managing the progress of the contract/build-up through its lifecycle may be the key differentiator between an offshoring experience and an onshore engagement.

- **Focus on transition management** – In traditional outsourcing deals a large number of employees are transitioned to a new firm, thus the majority of the processes and knowledge are retained. In offshore outsourcing, the supplier (and client) is tasked with knowledge transfer to a large block of new resources with no previous knowledge of the systems, corporate culture and industry. Transitioning of knowledge and key resources needs to be a much more focused and planned activity in offshore outsourcing. A detailed transition plan including a phased strategy to mitigate risk and manage productivity is critical. For those companies that have experience in onshore outsourcing, expect the transition to take more time than previous deals.

- **Change management** – Similar to onshore deals, offshore deals require a cultural change within the enterprise. Companies are faced with communicating this change to employees, customers, partners and other key stakeholders. As companies build offshore communication plans, consideration should be given to working in remote environments, cultural training, hybrid processes (of supplier and client) and global management.

- **Invest in Program Management** - After investing time and resources to plan, source and negotiate an offshore contract, clients need to continue to invest in the management phase and not rely on the vendor to carry the relationship. In-house expertise or a neutral third-party firm can help maximize the returns from implementation and delivery and make sure the engagement achieves full potential. Companies should expect to invest between 4% and 8% of the total deal value annually on offshore program management. Program management should focus on 5 key areas of financial, performance, resource, contract and relationship management.
Contact Information

For more details about neoIT’s offshore advisory and management services, please contact:

Allisson Butler  
Marketing Director  
San Ramon, California  
allisson@neoIT.com  
925-355-0557  
www.neoIT.com

neoIT Global Headquarters  
2603, Camino Ramon, 2nd Floor  
San Ramon, CA  94583 USA

neoIT Asia Headquarters  
210, Bellary Road  
Upper Palace Orchards  
Bangalore 560 080 India