Captives in India: Is the Honeymoon Over?

Executive Summary

The recent announcement of UBS, a global financial services firm, selling its captive in India to Cognizant Technolgies is the latest in a series of such sell-offs. This only reiterates what Evalueserve had predicted way back in 2007 that the capacity addition by third-party service providers ('Buy' option) is likely to surpass additions by captives ('Make' option). After a study of about 100 captives of western companies in India, Evalueserve confirmed that a majority of these captives are in serious trouble.

- Sixty-one percent of the captives studied have faced significant issues, with many of them already shut down.
- Smaller captives have been the worst hit; many of the larger ones are not in good shape either.
- Captives across all segments—Information Technology (IT), Business Process Outsourcing (BPO) and Knowledge Process Outsourcing (KPO)—have fared somewhat similarly.

In contrast, third-party service providers have been scaling up during this period. Access to new markets and increasing maturity of the service providers have helped them stay ahead.

Majority of Captives Face Serious Issues

In April 2007, Evalueserve predicted in a report titled 'The future of KPO – Make or Buy? that the capacity addition by third-party service providers ('Buy' option) is likely to surpass additions by captives ('Make' option). The report also identified three distinct phases in the lifecycle of offshore units in the 'Make' model: the set-up phase, the honeymoon phase and the stagnation period.

As a follow-up, Evalueserve studied 100 captives, not only from KPO, but also from BPO and IT segments that have been in operation since January 2006. These included 30 BPO, 38 KPO and 32 IT captives, from the 300-odd captives in India. In cases where the captive catered to overlapping areas (which was the situation in 34 percent of the sample), the predominant area of operation (i.e., IT/BPO/KPO) was selected to classify the captive. The captives were selected randomly and were of varying sizes with 54 percent of them having more than 500 employees.

The current study confirms the earlier theories. Sixty-one percent of the captives studied have gone through varying degrees of turbulence in the past four years—27 percent of them either shut down or were sold to third-party service providers. For example, Citigroup sold its BPO arm, Citigroup Global Services, to Tata Consultancy Services and its technology captive, Citi technology Services Ltd., to Wipro technologies. HCL Technologies bought Adaptech's India technology centre, Symphony Service bought biotechnology firm BioImagene's India R&D centre and the AOL contact centre in India was sold to Aegis BPO. Besides, companies such as Bose Corp., PowerGen, Riya, Inc. and BelAir Networks shut their captives in India.

Thirty-four percent of the captives studied either remained stagnant or have scaled down. These captives are under great pressure, and we may see many of them exiting in the next 1–2 years. However, small captives cannot be sold off at a premium, and they will find the exit much harder.

Small Captives Worst Hit; Larger Ones Also Not Spared

It is well established that smaller captives with fewer than 500 employees are likely to face greater challenges to survive. In fact, 74 percent of such captives have gone through a difficult time in the past four years. Employee retention is a serious issue in small captives since they are unable to provide good career opportunities.

An interesting finding from the study is that many bigger captives (with more than 500 employees) have also been under tremendous pressure to survive in the past four years. It is evident from the fact that only half of such captives have been able to scale up during this period. The break-up of how small and large captives under study fared, is depicted in the following diagram:

Chart 1: Captives with < 500 Employees

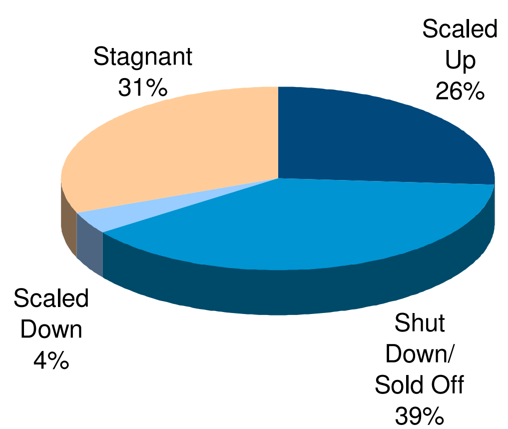
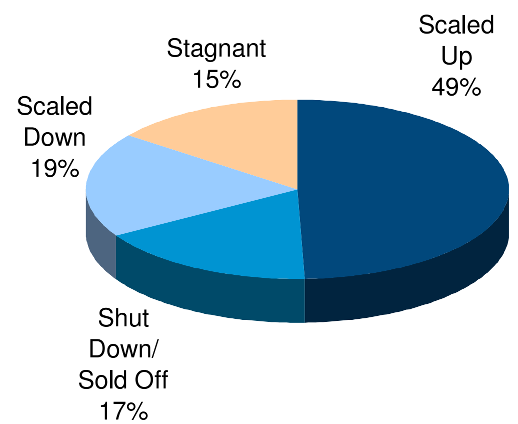


Chart 2: Captives with > 500 Employees

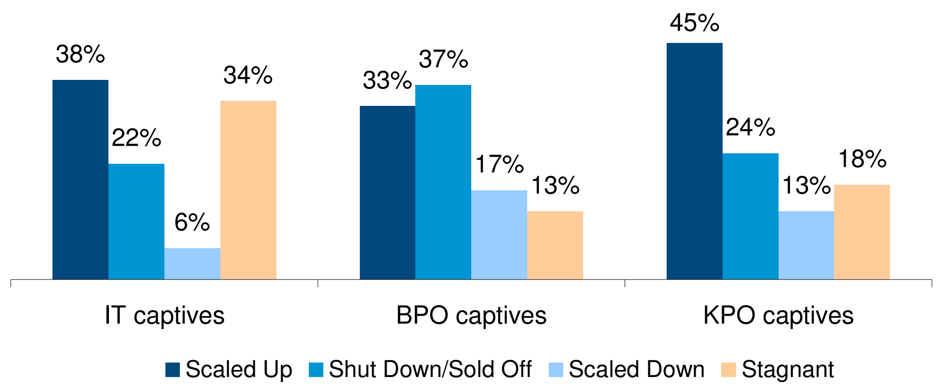


Source: Evalueserve

Poor Performance Across All Segments

Captives across IT, BPO and KPO sectors have all been hit somewhat similarly—62 percent of IT captives, 67 percent of BPO captives and 55 percent of KPO captives studied have had a difficult time in the past four years. The break-up is depicted in the following diagram:

Chart 3: Captives under Pressure: Sector-wise Break-up



Source: Evalueserve

What Led to The Decline of Captives?

The change in the position of captives from a seemingly 'enviable' position to an 'unviable' condition can be attributed to several factors. The most prominent of them are the following:

- Significant management involvement is required while setting up a captive. If the support is sporadic, the transitioning and ramp-up process slows down, leading to cost escalations. In case of third-party providers, the parent company can manage the vendor as per pre-agreed Service Level Agreements

(SLAs) and engagement terms, which does require some effort, but is much less than what is required for a captive.

- After an initial phase of intense growth—the honeymoon period—many captives tend to stagnate in size. This leads to higher attrition due to uninteresting work and limited career opportunities, which in turn increases recruitment and training costs significantly. Also, to attract talent, captives are often forced to pay a premium of 30–50 percent, further escalating the costs. In contrast, third-party providers use their scale and brand reputation to contain these costs very well.
- Captives have several hidden costs, including management time and travel costs, incentives to divisions in the parent firm to outsource work to captives, among others. All these drive the fully loaded costs of captives well beyond free market costs, making them unrealistic and unsustainable. According to Forrester, it is 25 percent more expensive to operate a captive centre than have an outsourcing firm do the work.
- The global recession in the past 12–18 months has accelerated the pace of decline. Many firms that have been under tremendous pressure to perform have realised that letting go of their bleeding captive centres can breathe more life into their already stretched financial statements. Apart from monetisation of assets, this also helps the firms to focus on core activities.

Third-Party Providers Scale Up

Meanwhile, third-party service providers have, by and large, been scaling up since 2006. Their basic advantage over the captives is that they are not bound by many of the constraints that the captives have. Therefore, these players can expand into new areas with differentiated offerings.

Several geographies outside the conventional markets such as the US and the UK have become increasingly open to the concept of outsourcing. Further, the share of the domestic market in India in the outsourcing pie has also gone up. Leveraging this, large IT and IT-enabled services (ITeS) firms in India have expanded and gained global foothold in the past four years. Interestingly, small and medium-sized firms have also been making the best use of such opportunities. According to a recent study by the India Brand Equity Foundation (IBEF) and Ernst and Young, mid-cap IT and ITeS firms have been expanding aggressively and exploring new markets.

NASSCOM, the apex body of IT and ITeS firms in India, estimates the combined (total) revenues of IT and ITeS services for 2008–09 at USD 58.8 billion, a growth of about 13 percent year-on-year despite the recession. Also, NASSCOM estimates that the industry grew at a compound annual growth rate of 28 percent in the past five years. Most of this growth has been through third-party service providers.

Which Captives Will Win The Race?

The answer seems obvious. If the data for the past four years is anything to go by, it is large captives with a well-defined growth strategy and excellent management focus that are expected to survive. Many of these firms are likely to keep their captives as centres of excellence and retain high-end core activities, moving everything else to third-party service providers. Innovative business models may emerge in firms' choice of 'Make' versus 'Buy'.

Global firms are becoming increasingly wary of starting new captives. For example, according to Zinnov Management Consulting, only 15 overseas technology firms opened IT captives in India in 2007, compared with 76, 70 and 48 in each year, 2004 through 2006. The figure fell even further in 2008 and 2009 due to the global slowdown. Given the poor track record of captives, the number of firms willing to go for the 'Make' option is likely to remain low in the coming years.

About Evalueserve

Evalueserve provides knowledge services to a global client base of Fortune 5000 companies, including Investment, Commercial and Retail Banks; Insurance Companies; Private Equity Firms; Corporates; Consulting and Research Firms; Law Firms and Intellectual Property Firms. Evalueserve's expertise covers areas such as Financial and Investment Research, Business Research, Market Research, Intellectual Property and Legal Support Services, Data Analytics and Knowledge Technology Services. Besides, we provide access to over 20,000 experts through our Circle of Experts.

We currently have more than 2,000 professionals in our research centres in India (Delhi-Gurgaon), China (Shanghai), Chile (Santiago-Valparaiso) and Romania (Cluj-Napoca). In addition, we have 65 client engagement managers located in all major business centres and regions around the world. We have sales offices in the Americas, Europe, Asia-Pacific and the Middle East.

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About the Authors

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Manoj is Vice President and Head of Business Research at Evalueserve. Prior to joining Evalueserve in 2004, Manoj served as a strategy and process consultant at Accenture, New Delhi, for about four years. At Accenture, he worked with several clients in India and abroad, with stints in Asia, the Middle East and Europe. Earlier in his career, he had also worked with Infosys Technologies, Bangalore.

Manoj manages a team of about 500 professionals focused on business research across various verticals, such as Telecom, IT, Life Sciences, Automotives, Energy, Chemicals, Consumer Goods, Retail and Logistics to cater to the needs of clients across the globe. Manoj has also been a speaker at several national events related to the services industry.

Manoj received his Bachelor's degree (B.Tech.) in Mechanical Engineering from the Indian Institute of Technology, Chennai, in 1997, and Master's degree (MBA) in Finance and Marketing from XLRI, Jamshedpur, in 2000.

Team:

A team of Business Research professionals at Evalueserve, comprising Jitesh Sah, Rahul Raghav, Neelu Sachdev, Pallavi Chauhan and Abhas Gupta, assisted Manoj in the research study behind this article.

Shashi Kukar and Laxmiprasad Rath conducted editorial review, and Seema Singh, Subroto Pal and Kamal Marwaha conducted design review of the article.

Marc Vollenweider, CEO and Co-founder of Evalueserve, authored the Evalueserve paper titled 'The Future of KPO – Make or Buy' in April 2007, and provided substantial inputs and insights to the current article.

Marc founded Evalueserve in December 2000, after spending a decade with McKinsey & Co (including two years as a Principal in Switzerland and India). Prior to starting Evalueserve, Marc established McKinsey Knowledge Centre in Gurgaon, India, and grew it from 14 to 120 professionals between 1999 and end of 2000.

Marc has vast consulting experience in various industries such as Telecom, Pharmaceuticals/Healthcare, Banking, Insurance, Steel, Transportation and Logistics around the world. He can be termed as a person who can live anywhere in world; learn the best of cultural, social and practical aspects; and work with people from various backgrounds to achieve a common objective. Marc has spoken at many events over the last few years and is regularly quoted on TV and print media as an Offshoring/Outsourcing Industry specialist. He is particularly renowned and much sought after for his conference presentations on the future of BPO and KPO.

Marc graduated from INSEAD, France, in 1991 with a Master of Business Administration (MBA). He also holds a Master's degree in Telecommunications Engineering (M. Tech.) from the Swiss Federal Institute of Technology, Zurich.