



CAPTIVE CENTERS

Strategic Assets or Competitive Disadvantages

Captive Centers, defined as company owned service centers in a low cost location providing a range of services to the organization, can offer companies more control, flexibility and potentially develop into a valuable asset. Likewise, mismanaged captive centers can consume resources, divert attention and create complex delivery problems.

This document explores what makes a captive center a strategic asset and the factors that can turn this asset into a competitive disadvantage. Learn how to keep a captive fit and when the worse case scenario develops, how to exit from the captive strategy.

Table Of Contents

About This Document	3
About Pareekh Jain	3
About Ralph Schonenbach	3
About Trestle Group Research	3
Introduction to Captive Centers	4
Business Models	5
Captive Centers as Strategic Assets	6
Turning Assets into Competitive Disadvantages	10
Keeping Captive Centers Fit	14
Health Check / Diagnostic	14
Process Reengineering	14
Human Resource Management	14
Strategic Re-evaluation	15
Program Management	15
Predictive Approach	15
Innovative Approach	15
When Enough is Enough - Exiting from Captive Centers	16
Conclusion	17

About This Document

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A seasoned consultant, Mr. Jain started his career as a software engineer with Geometric prior to moving to an outsourcing advisory firm. He has been a key contributor on a number of engagements with leading US and European clients, which have spanned across the outsourcing lifecycle. His expertise lies in operational improvement leveraging cost reduction opportunities through processes evaluation, redesigning and outsourcing. Mr. Jain has created a wealth of intellectual capital in the areas of IT applications and business processes assessment and redesigning. He is an upcoming thought leader and authored a variety of publications on topics related to outsourcing, process redesigning and regional competitiveness for outsourcing. Mr. Jain received his MBA from the Indian Institute of Management (IIM), Bangalore and a Bachelor of Technology from the Indian Institute of Technology (IIT) Delhi.

About Ralph Schonenbach

Mr. Schonenbach is the CEO of Trestle Group and on the Board of Trestle Group Foundation. He has held senior positions with the firms Andersen and Ernst & Young. Over the span of his career, he has established several successful consulting practices with a primary focus in the financial services industry and has advised high-level executives around the world on how to transform the way they manage and deliver services, as well as how to tackle the pressures brought about by resource constraints. Through Trestle Group Foundation, he is passionately involved with providing support to both women and emerging entrepreneurs in developing countries. He has held an Advisory Board position with the United Nations sub-committee, ICC (International Council for Caring Communities). Mr. Schonenbach frequently speaks at conferences and has authored a variety of publications. Mr. Schonenbach earned a degree in Business Management from Goucher College.

About Trestle Group Research

Trestle Group Research is committed to developing thought-provoking studies for executives across industries. Our experts analyze sourcing market trends working closely with industry leaders. Based on interviews, surveys and roundtable discussions, thought provoking studies are produced for the benefit of our clients and the market.

Our publications provide an introduction to themes that top executive agendas, combining research with expert opinions from the market. Examples of recent topics include:

- Change Management
- Shareholder Value
- IT Governance
- ITIL and Outsourcing Engagements

Introduction to Captive Centers

Captive center refers to an offshore center typically in a low cost country that is owned and operated by the company itself. In the captive center model, the company sets up its own subsidiary offshore so that the company owns all assets and staff. The company then sets up its own operations through hiring local staff and leveraging expatriate staff.

Captive centers have the advantage of the client retaining ownership and operational control while leveraging economies of the low cost location. Captive centers best serve clients that want to migrate core business processes or IT functions offshore. The motives for captive centers are determined in detail below:

Control

Captive centers are an obvious choice if the company has a need to have total control over the process, quality, timeliness, security, data privacy, etc.

Risk

Captive centers are a strong choice if the company needs to aggressively manage and retain control over their risk profile. Many firms that are regulated tend to manage their offshore business processes in captive centers, especially for critical business areas.

Domain Knowledge

A captive center is often the best option when there is a high need for industry- or domain-specific knowledge and suppliers in the offshore location do not have the required deep process expertise.

Proprietary Technology or Processes

With captive centers, companies have more control over proprietary processes or technologies, which require greater assurance of security/data privacy than can be provided by a third-party service provider.

Specialized talent

For specialist processes such as Insurance Underwriting or Taxes, there is a need for certified individuals who have extensive experience in a particular domain. Such individuals are becoming increasingly scarce in mature markets and can be very expensive to employ and retain. Local suppliers are not likely to train and retain these individuals unless they are involved in client work. Captive centers have a good chance of attracting top-talent for industry-specific skills.

Business Models

The dominant business model is a wholly owned center but there are a few varieties of captive center business models – Offshore Dedicated Center (ODC), Build-Operate-Transfer (BOT) and Joint Venture (JV).

Captives

- Wholly owned center established by the corporation
- Proprietary processes and equipment

Offshore Dedicated Center (ODC)

- Long-term contract with some risk sharing
- Shared processes but dedicated staff, equipment, and facilities

Build-Operate-Transfer (BOT)

- Wholly owned center
- Established by supplier and then transferred to another corporation

Joint Venture (JV)

- Multiple owners as center shared by multiple clients
- May turn internal cost center into profitable enterprise

Captive Centers as Strategic Assets

A properly established captive center that is well maintained is a strategic asset to its owner.



Fig 1: Captive Centers as Strategic Assets

Economies of Location

The majority of costs associated with IT and business process operations like manpower, facilities etc. are function of location. By leveraging operations in low cost locations, companies can leverage economies of the location.

Economies of Scale

IT services and business processes exhibit economies which are achieved by increasing the scale of operations while reducing the per unit cost. A company whose operations are geographically diverse may consolidate many IT functions and business processes into the captive center and thus benefit from economies of scale.

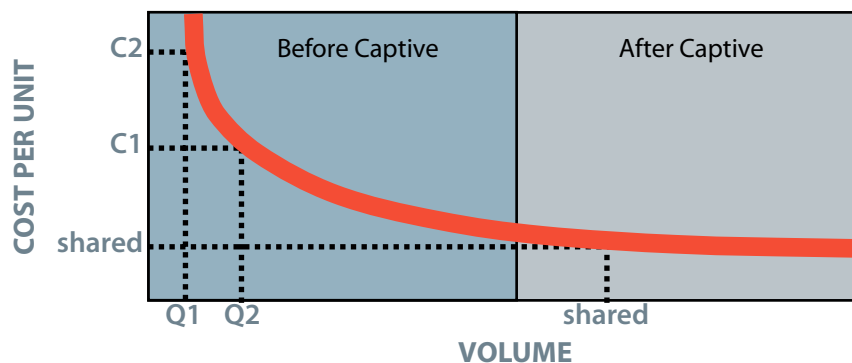


Fig 2: Economies of Scale

Economies of Scope & Utilization

When the scope of services is increased in captive centers and many services are consolidated and centralized, manpower is utilized collectively versus via individual centers. The utilization levels are improved and companies need to plan less for uncertainty.

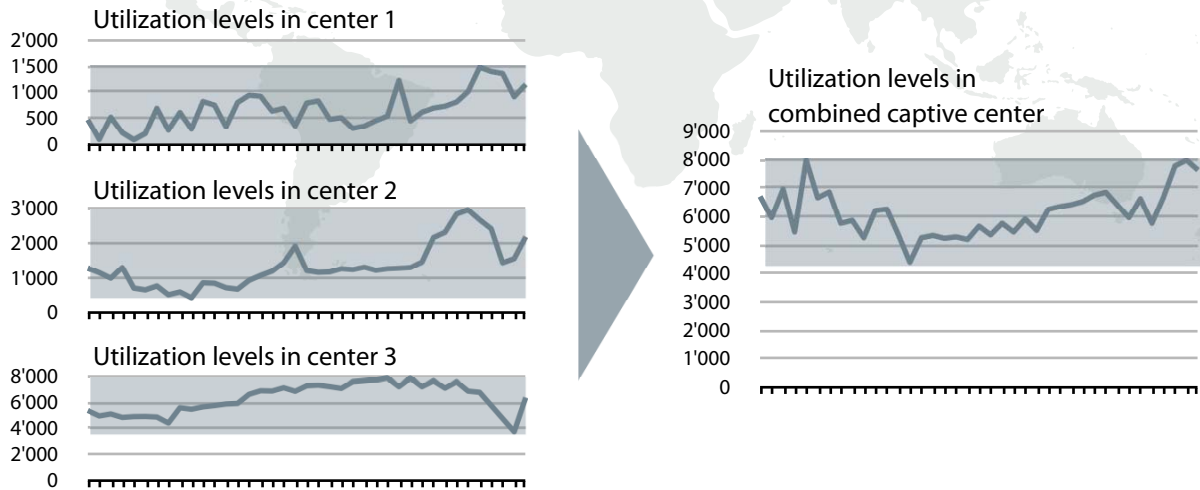


Fig 3: Economies of Scope & Utilization

Mergers & Acquisition (M&A) Advantage

Captive Centers help achieve M&A synergies quickly. Much of the synergies in M&A are in Selling, General and Administrative (SG&A) overheads. The majority of SG&A services can be performed in captive centers. If the parent company acquires a new company, it's SG&A functions can also be performed from the same captive center. This helps reduce integration time, achieving synergies and launching common process across merged entities.

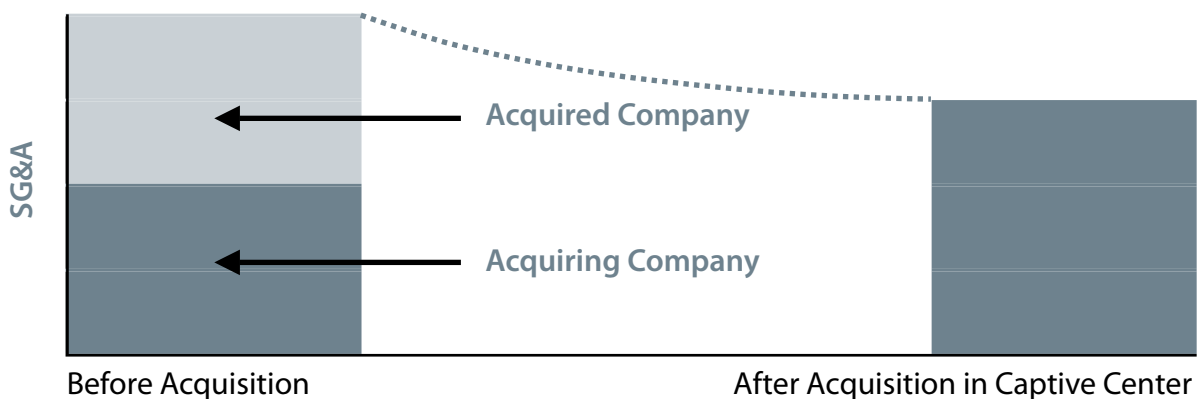


Fig 4: M&A Advantage

Planned Demand & Supply

Once centers are scalable, they can better plan manpower requirements. The combined center can ramp up and down based on business requirements more efficiently than individual small centers.

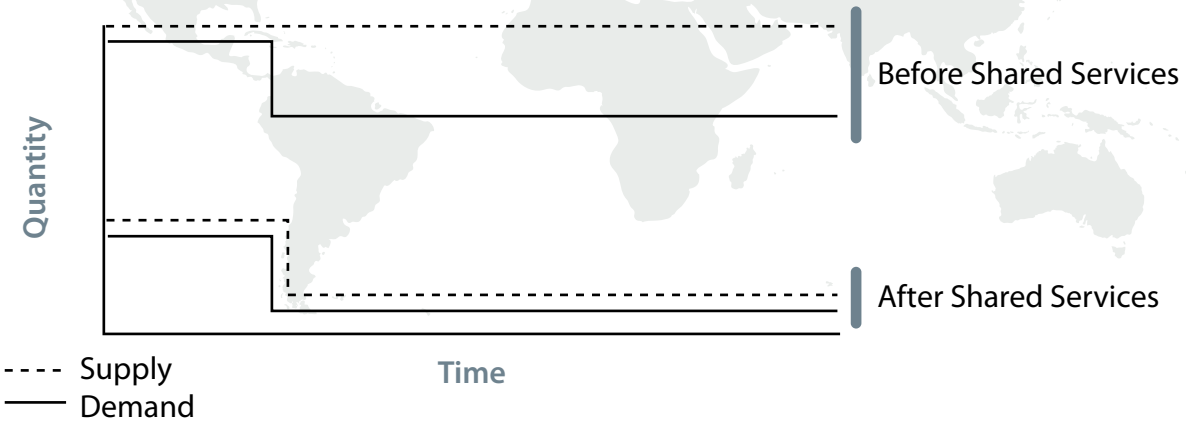


Fig 5: Planned Demand & Supply

After Shared Services, less resources are consumed due to user cost accountability and the organization benefits from planned demand and supply.

Process Improvement

Captive centers can improve and streamline the consolidated processes through:

- Process reengineering
- Process standardization
- Best practices proliferation

Global Service Levels

When service levels vary across an organization, the consolidation and improvement of processes can help attain consistent global service level agreements.

Reducing Time to Market – New Product Launches and New Locale Entry

Captive centers enable launching new products or entry into new geographies quickly. The standardized and consolidated business processes in captive centers help extend those to new products and new geographies quickly thus enabling faster product or geography rollout.

Reducing Time to Market using Captive Center

Captive centers can be leveraged in reducing time to market in new product development if they are in different time zones. The gap in time zones can be leveraged by reengineering the product development process into a series of small sequential steps, which can be performed in different time zones and thus reducing the overall development time.

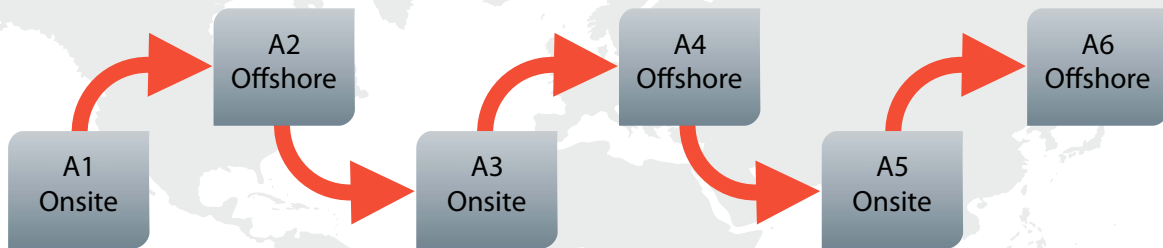


Fig 6: Reducing Time to Market using Captive Center

IP Protection, Security & Privacy

Since captive centers are company owned with full control they can better protect IP and are less prone to security breaches via a third party service provider.

New Revenue Stream

Captive centers can be a source of new revenue streams as well. Many revenue streams or opportunities are not feasible for companies to pursue in their home country due to the high cost involved. However, with captive centers offshore, the cost equation changes and segments, which were not economically feasible earlier, become viable.

Other opportunities are localization of products for local market and developing countries. Due to high cost involved and lack of localization expertise in developed countries, these companies were not pursuing local market opportunities – now they can with captive centers.

Global Talent

In this globalized world there is an increasing need to have global talent. Captives provide opportunities to recruit and develop staff globally. Captives can find talent in local markets and promote high potentials to global roles in the parent organization.

Also, companies can distribute talent from other geographies into captive centers providing global exposure. Afterwards, these skilled managerial resources can be leveraged and redeployed to other global locations.

Turning Assets into Competitive Disadvantages

As discussed earlier, captive centers can be strategic assets providing companies a distinct competitive advantage. However, if not managed well these strategic assets can turn into competitive disadvantages, as described below.

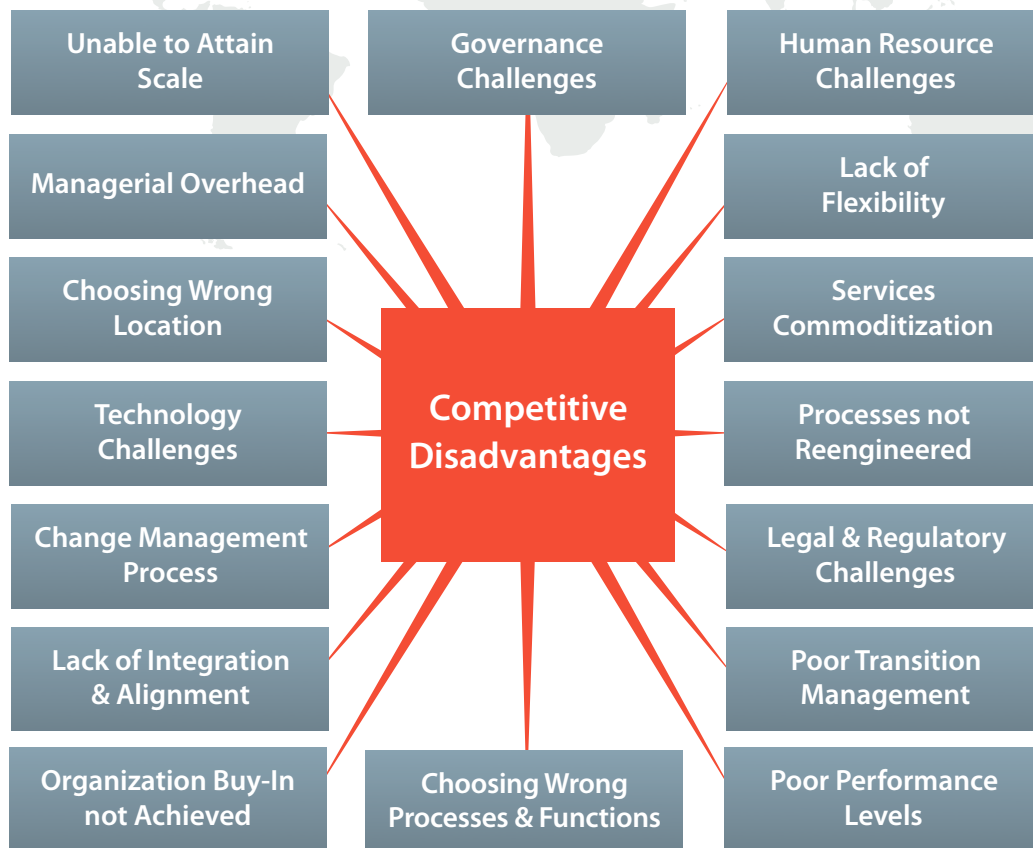


Fig 7: Captive Centers as Competitive Disadvantage

Unable to Attain Scale

One of the premises of a captive center is to attain economies of scale by combining work from different business units into a captive center. If this is not achieved, they will have high cost structures. The establishment of a captive center requires significant upfront fixed cost and if it isn't recovered through anticipated projects, the captive center will become uncompetitive and economically not viable.

Managerial Overhead

Managing a captive center in an offshore location is not easy. Organizations find task implementing and on-going management of parent company policies, procedures, systems and processes challenging. By outsourcing non-core activities, management is able to concentrate on their core activities providing a competitive advantage. However, a captive center, which is not managed properly, will create the opposite scenario, demanding greater management attention on non-core activities.

Organizations that transfer significant numbers of expatriate resources to the captive center may also find that costs are inflated while local needs of the staff are not addressed due to cultural differences and resistance.

Organizational Buy-In not Achieved

Organizations that expect quick wins from their captive centers will soon be disappointed when results are not delivered. A backlash to the captive begins through the following:

- Captives do not get work from other business units.
- Captive center's capability and viability is questioned.
- Business units do not work collaboratively to improve performance.
- Third party outsourcers get preference over captive.
- Difficult to get funding for further capital expenditure.

Human Resource Challenges

Captive centers face daunting human resource challenges in offshore markets, where demand of quality resources are outstripped by supply. Captive centers are competing with third party suppliers for talent, which offer a defined career path and good onsite opportunities. Captives try to offset with higher compensation packages, but many times face high attrition. Specific challenges include:

- Lack of onsite opportunities
- Lack of defined career path
- Parent company's different culture is insensitive to local working environment
- Higher salary structure to attract talent
- High attrition level

These HR challenges have a profound impact on cost, quality and productivity of the captive centers, which can turn potential strategic assets into competitive disadvantages.

Lack of Flexibility

Captive centers can lack the ability to add resources in cases of spikes in demand in comparison with third party outsourcers. The reasons can be lack of HR processes, hiring policy and scarcity of talent. Captive centers maintain a much smaller pool of resources compared to third party outsourcers who can utilize their pool of resources over much larger sets of clients. This adds to their perceived inflexibility in responding to business needs and results in lack of buy-in from business units.

Choosing Wrong Location

Location decisions are crucial and often irreversible. If a wrong location is chosen both at a country and city level, the captive center can quickly become a competitive disadvantage. Some of the location decisions of captive centers are based on the personal choice of key expatriate employees, which may

not be the right choice for the company in long run. It may be difficult to find the right talent and the cost of operations may turn high.

Poor Performance Level

Poor performance, needless to say, can turn any strategic asset into a competitive disadvantage. Poor performance in captives can be due to many reasons such as:

- Performance criteria like Service Levels Agreements not defined properly
- Performance not measured periodically
- Service Levels not improved
- Productivity not increased
- Best Practices not proliferated

Poor Transition Management

Transition planning and management is critical for the success of a captive center. Unless there is proper knowledge transfer and a process or function is effectively transitioned, it is unrealistic to expect that the captive center will perform well. This may require lengthening the stay of critical people from the original team who have the necessary knowledge. Different management styles adopted by the parent company's transition team and the local transition management team can be detrimental to the success.

Lack of Integration & Alignment

There is clear talk of aligning business with IT to achieve desirable performance. When IT is located in a captive center offshore, alignment becomes increasingly difficult. The lack of inclusion of captive IT centers in the overall business strategy development can turn them into a competitive disadvantage. When there is minimal integration and alignment with the parent company's operational philosophy or culture, the offshore captive centers are not able to deliver high quality IT work.

Choosing Wrong Processes or Functions in Captives

Every process or function cannot be performed offshore. Processes or functions should be qualified on measurable attributes and risks should be clearly identified. Progressive companies perform comprehensive IT and business process assessments to determine what can be sent offshore to captive centers and what is not possible. If a wrong choice is made, no matter how good the management is and how well the task is performed, it will fail to meet expectations.

Legal & Regulatory Changes

Legal & Regulatory changes, both in countries where the business is situated and where the captive center is located, can quickly turn strategic assets into a competitive disadvantage. Regulatory requirements such as SOX, data protection, HIPAA might warrant tighter security controls which may become too costly to implement. As offshoring goes mainstream, there will be more regulatory pressure especially on captive centers to comply with strict regulations. Tax and business laws in the captive center country like taxation, restrictions in hiring and firing, working hours regulation etc. can often make captive centers difficult to manage and result in a center that is economically unviable.

Processes not Reengineered

New models require new ways of working. In the case of captive centers, apart from new operating models, a part of the company is located in an offshore country in a different time zone. This will require new processes and new ways of conducting business. To ensure work is delivered efficiently, reengineering and transforming old workflows is required. Handoff points need to be clearly identified and proper service levels and performance parameters need to be designed. Unless these are done properly, captive centers will tend to become a competitive disadvantage instead of strategic assets.

Change Management Challenges

Planning and reengineering is not enough unless it is implemented well. The biggest hurdle in implementation is change management. When people are used to do work in a certain way dealing informally with their units, dealing formally in a far off center will not be easy. Also, uncertainty and fear of job loss can aggravate this problem. This will require professional change management support to handle this and ensure smooth implementation.

Governance Challenges

Captive centers will require effective governance as the organization will be challenged with staffing, new working styles and formal/informal information systems. Management will need to develop policies and practices to incorporate a more flexible approach to labor allocation. Management structures will need to support relationships with offshore operations and assure that objectives, contracts, delivery models, and measurement are aligned. Program and process management must address the advantages and challenges presented when part or all of a project "moves offshore," and managers must develop and disseminate best practices for achieving project success, cost savings and quality assurance.

Technology Changes

Captive centers are either directly involved in technology development / maintenance activity or involved in business processes whose backbone is technology. Technology evolves at a rapid pace. Captive centers not able to keep pace with the changes in technology, will create a competitive disadvantage amongst their peers.

Commoditization of Services

Services that are consolidated and centralized offshore become commoditized over a period of time. When competitors are able to offer similar services as the captive center at lower prices, the captive center is at risk. Unless the captive center can demonstrate continued value to the organization, the asset will soon turn into a competitive disadvantage.

Keeping Captive Centers Fit

As we have seen earlier, captive centers that are strategic assets can quickly turn into competitive disadvantage. They need to be kept fit by constantly reviewing planning and resolving issues. Steps which captives can do to ensure they remain fit include:

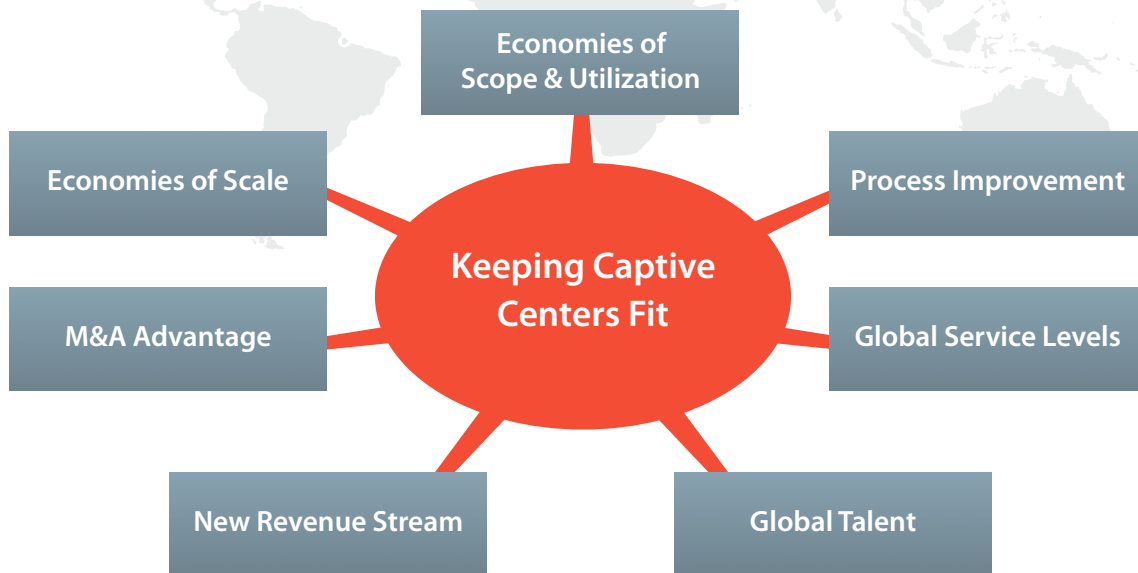


Fig 8: Keeping Captive Centers Fit

Health Check / Diagnostic

Captives can do an honest health check - a diagnostic exercise to see what is working and where problem areas are. Health checks can be done through industry experts by examining the strategy, operations, human resources, finance, technology, security, as well as compliance versus industry best practices. Based on the health check results, an improvement plan can be designed and implemented to make captive centers fit.

Process Reengineering

Processes and procedures change over time. Reevaluating the efficiency of the processes and the cost can highlight areas for improvement.

Human Resource Management

If human resources related issues like attrition, recruitment, training, and productivity are a problem, analyzing the root cause is critical. Solutions can range from small creative steps like shifting working hours, changing recruitment profiles, industry salaries and benefits to longer term steps such as company branding, career growth paths, employee rotation policies, maintaining benchmark levels, etc.

Strategic Re-evaluation

Market conditions and requirements often affect strategies. Re-evaluating the strategy and motives of establishing the captive center is important. When re-evaluating, consider:

- Feasibility of captive location for present and future requirements
- Portfolio assessment to determine what can be done in the captive, and what is not feasible
- Assessment of internal business development so that the captive satisfies estimated economies of scale and scope

Program Management

What is difficult to measure, is difficult to fix. Many competitive disadvantages are due to lack of proper program management, performance measurement and follow-up. Establishing a proper program management office (PMO), which coordinates all projects and inter-departmental communication, measurement of metrics and analysis of root causes can go a long way in making captive centers successful. Also, showcasing performance can generate additional buy-in across the organization for the captive center.

Predictive Approach

Predicting what may happen in the captive center based on industry trends and changes can raise warning flags if patterns begin to occur. Regularly monitoring employee behavior can give predictions about attrition providing enough time to implement corrective changes in the work environment. Short, weekly project reports providing summaries of high-risk items can alert and attract senior management attention. If systems and processes are designed for a predictive approach, warnings can provide opportunities to prevent unwelcome surprises.

Innovative Approach

Apart from other approaches mentioned earlier for keeping captive centers fit, there are innovative approaches that can help captive centers overcome some of their competitive disadvantages. Some of these innovative approaches are described below:

- **Subcontracting** – When specialized skill sets are not available or there is short-term spike in demand for resources, utilizing subcontractors for some of the work can help the captive center respond in an efficient and cost effective manner.
- **Providing outsourcing services to other companies** – When economies of scale are an issue, captives may consider taking some of the work from other companies, which does not create a conflict of interest with the parent company.
- **Management Contract** – When management of the captive center is an issue, companies may consider providing a management contract to run the captive for a proportionate fee subject to meeting SLA's. There are independent captive management agencies, which can manage captives on contract.

When Enough is Enough - Exiting from Captive Centers

Despite all good intentions and the dedication of resources, some captives do not become strategic assets. Some reasons, which can make a captive center not viable, include:

- Unable to achieve scale
- Commoditization
- Costs
- Technology change

Management must be open and honest with itself. If the numbers do not add up and a solution is not recognizable, it is time to consider existing. Some exit options include:

Shutoff

Companies can completely move out and shut down the captive operations. The employees are laid off and work is transitioned back to other centers or units as the case may be.

Complete Sell-off

Companies can completely sell-off their captive to third party service providers or a group of investors. The new management can continue to provide services to the parent organization. The contract terms, etc. need to be decided.

Hive off

A captive center can have a partial sell off or hive off of departments, which are commodity businesses to third party suppliers, while retaining other strategically important work in the captive centers. Third party suppliers can continue to provide services to the parent organization. The contract terms, etc. need to be decided.

Like closing a business, an exit is not easy. Apart from deciding the options, planning is required for:

- Employees – What are appropriate severance packages? Does the organization want to retain outstanding employees which can be relocated to other centers?
- Work – What will happen to the work being performed by the captive? Will it be transitioned to another center or to a third party?
- Stakeholders – What will be the impact on the different stakeholders? What will be the communication to them?
- Legal liabilities - What are the legal and tax liabilities in the country where the captive has operations?
- Assets – How will the company dispose of land, building, software, hardware and other assets in order to ensure their salvage value?
- Processes - How will workflows be adjusted based on the exit strategy?

Conclusion

When considering the establishment of a captive center, management should realize that this is more than a cost optimization exercise. The captive center is an extension of the organization established in order to thrive and consequently will require the appropriate levels of support.

Invest time to fully understand which captive business model is appropriate for the business: Captive, Offshore Dedicated Center, Build-Operate-Transfer or a Joint Venture.

As market conditions and demands change – re-evaluating the captive center strategy and the performance of the center regularly can prevent this strategic asset from turning into a competitive disadvantage.

Keeping captives fit through health checks/diagnostics, process reengineering, human resource management, strategic revaluation and dedicated program management will ensure that your center remains an asset. Predictive and innovative approaches will help minimize potential challenges that may divert senior management attention.

With best intentions, not all endeavors are successful. Knowing when to exit from a captive center and acting on this information can prevent what assets remain from disappearing completely.

At Trestle Group, we understand that captives can deliver value when implemented and managed properly. Our experts work with corporations to help develop their strategies, implement the business model and keep the operation fit. We wish you much success in this strategic venture and look forward to working with you.

TRESTLE GROUP

Trestle Group is an international firm providing services solely focused on global sourcing. Through our diverse and complementary set of services, clients benefit from support ranging from consulting to philanthropy. Whether you are interested in setting up operations in Eastern Europe or India, learning about best practices, recruiting talented professionals, exploring investment opportunities or simply making the world a better place, Trestle Group is a solid partner. We welcome you to experience our organization today.

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