

## Are you sure about offshore?

### What are the opportunities and what are the extra risks?

By François Zielemans, Protiviti

#### Introduction

The current economical situation requires creative solutions of managers to cope with short and long term effects on the organization. Faced with the unexpected severity of the downturn, many organizations will tend to 'freeze' strategic decisions and concentrate on the immediate operational problems. However, does this also mean that organizations can best put all initiatives aimed at the outsourcing of internal activities on ice?

Reducing costs by firing employees can not be sustained indefinitely unless the corresponding activities are eliminated. By means of three questions, this article aims to give some insight in the (im)possibilities that (offshore) outsourcing has to offer to relieve the pain in these difficult times.

#### Is the outsourcing of a shared service center a solution?

One of the effects that are the direct consequence of the financial turbulence is an increase of organizations that sell shared service centers in other countries (so-called 'captives') to wealthy suppliers. This instrument for quickly (somewhat) improving the liquidity position is used by Citigroup. For example, end of 2008 Wipro took over an Indian software development part for \$ 100 million and Tata Consultancy Group (TCS) took over a shared service center in which several financial back office processes are concentrated. This was a transaction of \$ 505 million in exchange for a nine-year service contract with a value of \$ 2.5 billion. Because only the wealthiest suppliers can finance this type of transaction, it is likely that the frequency will remain limited. Like other organizations, most suppliers are reliant on banks for financing these kinds of acquisitions. Other sales limiting factors are the relatively low financial value of the transaction because of the low book value and low margins, and the low impact on the liquidity position (Citigroup: \$ 605 million from the sale versus \$ 4,000 million capital injection from the United States government to restore the ratios).

A related situation is obtaining a captive as part of an acquisition. An example is the acquisition of Merrill Lynch by the Bank of America who both have a captive in India. The Bank of America then had the option to merge both captives, to eliminate the acquired activities or to outsource. Suppliers regularly bid on shared service centers (ssc's) that are for sale, because it gives them the opportunity to obtain market share, customer knowledge and a long-term service contract. An example is the interest of the India's Wipro, Satyam and the much smaller Copal Partners in a captive of the plagued Lehman Brothers. However, all three missed the boat for a Japanese financial service provider eventually succeeded in buying the captive. In the Netherlands, such scenarios are less like, because here captives are less used and because Dutch companies are hit less hard by the crisis than U.S. and British organizations.

The examples used so far are a direct result of the credit crisis and have little to do with a sound strategic choice and will hopefully not affect the Dutch businesses. However, whether or not to sell an ssc or captive is a question that an organization, regardless of the economic situation, has to ask itself every now and then. When creating an ssc the activities carried out can still be considered as strategic and/or risky, but this often changes when the organization continues to develop. Examples from a strategic standpoint are the sale by General Electric of a 60% share in GE Information Services (Gecis) to two investment firms, General Atlantic Partners and Oak Hill Capital Partners, for \$500 million and the sale of Indian captives by the British insurer Aviva for \$230 million to supplier WNS Global Services. In both cases a sound decision-making and selection process preceded the sale. Dutch examples are the acquisition of KPN's HR shared service center by LogicaCMG, Philips' sale of its financial ssc to the Indian Infosys and the acquisition of the financial ssc of Unilever in South America by CapGemini.

**Answer to the first question:** Only sell a shared service center / captive for the right reasons: the used intellectual property offers no longer competitor advantage and/or a supplier can further realize economies of scale and introduce new best-practices and innovations more quickly.

### Do the advantages of outsourcing currently outweigh the disadvantages?

The current market conditions offer potential outsourcers both opportunities and threats. First the positive news. The United States remain the largest market for suppliers, measured in total contract value, but it is also the country hardest hit by the crisis. The huge drop in demand combined with a devaluing U.S. currency against emerging economies, causes major concerns in boardrooms of suppliers that operate from e.g. India, the Philippines, China or South-Africa. Currency fluctuations can be covered in a contract but the dependency of the United States asks for diversification of the business model. For this reason, many foreign suppliers are currently extremely driven to gain a foothold in continental Europe and other markets.

For those Dutch organizations that dare to outsource now this can have positive consequences. In order to obtain the first customers, these suppliers will sooner be inclined to 'buy in' by offering favorable conditions. Later, they hope to catch up with the loss on the first assignments with new contracts. However, what may be an advantage for the outsourcer is unfavorable for the local European suppliers who will continue to see the price pressure increase. The local European players have the challenge of convincing the client of their innovative solutions and knowledge of the local market, rather than to compete on price.

The possible threats come in the form of additional operational and political risks. One of the effects of an economic downturn is that fraudulent activities sooner come to the surface. While the whole world is under the spell of the \$50 billion pyramid game of Madoff, the Indian market is under the spell of the fraud at Satyam and a bribe scandal at Wipro. Although the fraud by Satyam's CEO of \$1 billion is nothing compared to Madoff, the effects in India are not any less. As with banks, trust is very important for suppliers and the Indian government already has responded with proposals for additional regulation to limit the reputation damage. However, cases of fraud by a CEO or by employees can never be completely prevented and are not a specific risk associated with outsourcing.

Large-scale fraud can lead to unexpected side effects. At Satyam, in a couple of day 15,000 employees placed their resumes on the internet, looking for another job. This kind of 'exodus' is a direct threat to the operational provision of services and one of the risks of outsourcing compared to an ssc or a captive. Another related risk is that suppliers completely specialize in services to one industry. Several suppliers that focus on certain niches in the financial sector are now in trouble and already there is speculation on a number of bankruptcies among the smaller players.

The only group of suppliers that is really profiting of the malaise on the short term is active in Legal Process Outsourcing (LPO). These parties see a sharp increase of bankruptcies and acquisitions, especially from the U.S. For most suppliers, like Sasken, the short term outlook is less rosy. Sasken saw its share fall by 16% on the stock exchange after one of its customers, the Canadian telecom manufacturer, applied for a 'Chapter 11'.

The last attention point is political in nature. Although terrorism is not a recent development, recent attack in India (more than 600 deaths in the last 6 years), the Philippines (10 deaths in six attacks in just the month of July in 2008) and China (several attacks in 2008 with more than 25 deaths as a consequence) have lead to, among other, risk surcharges by suppliers because of higher insurance premiums. The outsourcers themselves are often also confronted with higher costs because Western employees send to a risky country want to be paid more as compensation. Both effects are putting pressure on the business case but it is not to be expected that countries like Vietnam will now suddenly become much more popular. Companies that dare to outsource in these uncertain times will opt for the familiar names, both for countries and suppliers. As with fraud, exposure to conflicts can never be completely prevented, but it is good to be aware of it and to take it into account when preparing a business case.

**Answer to the second question:** Outsourcing has become an integral part of business and offers plenty of opportunities, also in these times. However, do not forget the impact of currency fluctuations, inflation adjustments and increased risk premiums when preparing a business case. Also, spend sufficient time on choosing a suitable supplier and an exit strategy in case the supplier goes bankrupt or is taken over. And last-but-not-least: it is very tempting to completely squeeze the supplier in these times, but also now applies: you get what you pay for. Eventually, every organization has to determine individually whether or not the potential advantages outweigh the disadvantages.

#### What to do with ending and current outsourcing contracts?

Risk aversion and time pressure because of more pressing problems lead in most organizations to maintaining the existing status quo with suppliers. Of course, this is an understandable reaction. However, be alert to the possible consequences of the economic crisis on the suppliers. To reduce costs, their innovation budgets are also under pressure which will lead to (even) more pressure on intentions surrounding 'strategic partnership' and 'adding value'. This may result in a situation in which the owner of the contract expects the supplier to fulfill its innovative obligations, while the supplier expects that the economic situation will allow for postponement.

For the most important contracts, examine the clauses for possibilities for contract termination and who bears what costs at an exit. This, in case the supplier, for whatever reason, fails to fulfill its obligations. At the same time, think of possible alternatives to continue the service, like in-sourcing or another supplier.

For contracts that are ending an outsourcer has two possibilities: continuing with the current supplier or a more risky approach by outsourcing again with the potential of a better end result. If the first option is chosen, it is recommendable to at least conduct run a benchmark to check what is common in the market. If the second option is chosen, it is advisable to take sufficient time to come to a contract, despite the financial pressure to show results quickly. The negative financial impact of a bad impact is much greater in the long term than the positive effect on the result of this year. Also, sign contracts with a relatively short duration and a limited contract value. Consider other risk mitigating measures such as a longer and gradual transition period for the transfer of activities to the supplier. But that interesting deals can be closed is illustrated by the article in The Economic Times showing that Indian suppliers alone have given \$300 million in discounts on new contracts.

**Answer to the third question:** Depending on the willingness of the organization to take risk ('risk appetite'), determine the available time and the possibilities the supplier market offers for handling ending contracts. Schedule enough time in order to come to the desired end result and keep in mind that a price that is too low will always come at the cost of a loss of quality. Also, do not hesitate to check if it is possible to negotiate a sharper price or a lower compulsory purchase for current contracts.

#### Forecast for 2009

Despite a growth of the number of signed contracts in 2008, it is plausible to presume that the market will stabilize in 2009 and will only improve afterwards. The expected decline in the growth of the number of contracts will impact the supplier market. On the one hand, a 'shake out' in which a number of rotten apples will be removed from the basket and on the other hand a consolidation of small and middle-sized suppliers to be able to face the economic malaise.

The recovery will depend on the moment on which potential outsourcers will be able to again make time to take strategic decisions and are willing to accept the risk associated with outsourcing. For those who already dare to, there are enough opportunities for a beneficial agreement. However, besides a strong stomach, this asks for the necessary patience and understanding of the market.

### About the author

François Zielemans is senior manager at Protiviti and specialized in outsourcing issues and the management of the associated risks. He can be reached via [francois.zielemans@protiviti.nl](mailto:francois.zielemans@protiviti.nl).

### Article from Protiviti KnowledgeLeader – [www.knowledgeleader.com](http://www.knowledgeleader.com).

*KnowledgeLeader is a subscription-based website that provides audit programs, checklists, tools, resources and best practices to help internal auditors and risk management professionals save time, manage risk, and add value. Free 30-day trials available.*

### About Protiviti Inc.

Protiviti is a leading provider of independent risk consulting and internal audit services. The company provides consulting and advisory services to help clients identify, assess, measure and manage financial, operational and technology-related risks encountered in their industries, and assists in the implementation of the processes and controls to enable their continued monitoring. Protiviti also offers a full spectrum of internal audit services to assist management and directors with their internal audit functions, including full outsourcing, co-sourcing, technology and tool implementation, and quality assessment and readiness reviews.

Protiviti, which has 60 locations in the Americas, Asia-Pacific and Europe, is a wholly owned subsidiary of Robert Half International Inc. (NYSE symbol: RHI). Founded in 1948, Robert Half International is a member of the S&P 500 index.

*Protiviti is not licensed or registered as a public accounting firm and does not issue opinions on financial statements or offer attestation services.*