

White Paper



Research Study of Captives in India and China: A Majority of Parent Organizations also rely on Third-Party Relationships!

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Abstract

Establishing captive centers continues to be a key option in organizations' outsourcing strategies. Continuing Infosys' work on captives¹, we researched captives with a special focus on the role played by them in meeting the sourcing needs of organizations. The scope of research included captive centers in India and China. Our study unearthed rich data on captives – organizations adopt a portfolio approach to outsourcing, where captive centers are accompanied by strong third-party vendor relationships in both India and China, with work being allocated between the two based on their special capabilities. Captives typically work in areas that are either core to an organization or require strong intellectual property protection, while third-party relationships dominate non-core areas. Despite strong incentives to take up more work in-house in order to generate economies of scale in a captive, our research indicates that a well-planned allocation of work is crucial for creating successful captives.

¹ Captives in India: A Research Study:
<http://globalsourcing.infosys.com/white-papers/captives-research-v2.pdf>

Role of Captives in the Flattening World

The relocation of IT and business process services to India and China is driven by global mega trends that are leading to the creation of the Flat World². Although offshoring of services to low cost locations in Asia, Latin America and Eastern Europe is increasing, India and China remain the most attractive sourcing destinations. Both these nations offer a large talent pool at a low cost and are also emerging as attractive markets on their own. Not surprisingly, India and China are also the main destinations for captive centers that provide IT and business process services to parent organizations.

Infosys has been researching companies to understand the sourcing strategies underlying captives. As part of the research (conducted in late 2006/ early 2007), we undertook a study of 394 organizations for their India presence and 197 companies for their China presence. The companies selected across various industries ranked in globally recognized lists such as the Fortune Global 500, as shown in Figure 1.

Of the 394 companies studied for their India presence, 309 (78%) were offshoring to India through captives and/or third-party vendors. In China, the corresponding figure was 64% of the 197 companies studied, i.e. 127 companies.

Outsourcing to third-party vendors is the dominant model for relocating services to India and China. About 94% of the companies offshoring to India and 92% of them offshoring to China have adopted third-party outsourcing. While companies opting for third-party vendors may also have captives working in parallel, companies engaged in offshoring exclusively through captives account for a small fraction. 77% of the companies that have captives in China also have thirdparty relationships, while that number is 85% for India. This comparison is detailed in Figure 2.

Industry	India	China
Aerospace & Defense	12	6
Automobiles & Parts	26	15
Energy & Resources	32	19
Financial Services	109	59
Healthcare	15	6
Industrial Engineering	19	7
Retail & Consumer Goods	62	33
Hi-Tech	65	29
Telecommunications	25	13
Transportation & Other Services	29	10
Total	394	197

Figure 1: Industries and number of companies covered in this research

Source: Infosys Research

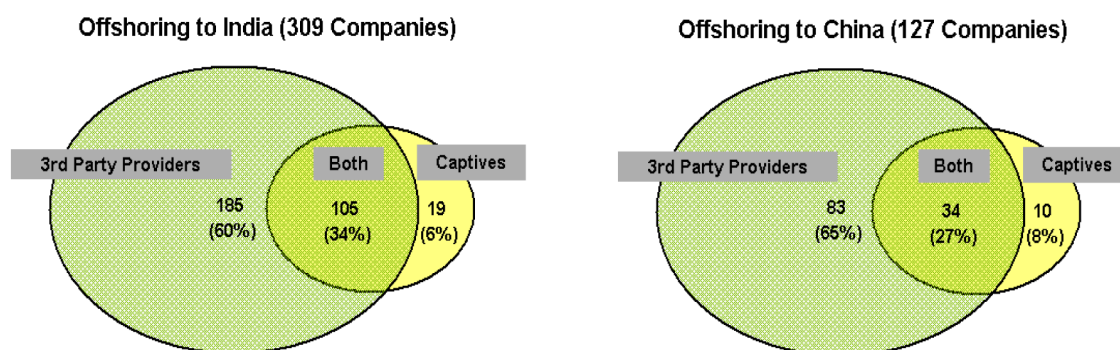


Figure 2: Usage of 3rd party providers and captives amongst companies that offshore to India and China

Source: Infosys Research

² Mastering Flat World Shifts Through Modular Global Sourcing:
<http://globalsourcing.infosys.com/white-papers/mastering-flat-world-shifts.pdf>

We see similarities in the overall sourcing pattern in India and China. As in India, third-party relationships dominate in China and very few companies depend exclusively on captives for offshoring.

Verticals Setting Up Captives

Our research indicates that setting up a captive as the sole sourcing option constitutes a small part of offshoring. This is because captives can be risky and often expensive ventures, which require in-depth understanding of local business practices, talent availability and regulations. This typically comes from prior experience in offshoring through the Global Delivery Model. Moreover, the commitment and management bandwidth needed to set up and run a captive is high. Hence, there has to be a much stronger justification for setting up a captive as compared to setting up vendor partnerships. Our data shows that the Financial Services and Hi-Tech industries have gained maturity and therefore have more captives – in numbers and as a percentage, while the other industries don't yet see captives as an attractive offshoring option.

Figure 3 shows offshoring trends in the various Indian industries included in our study.

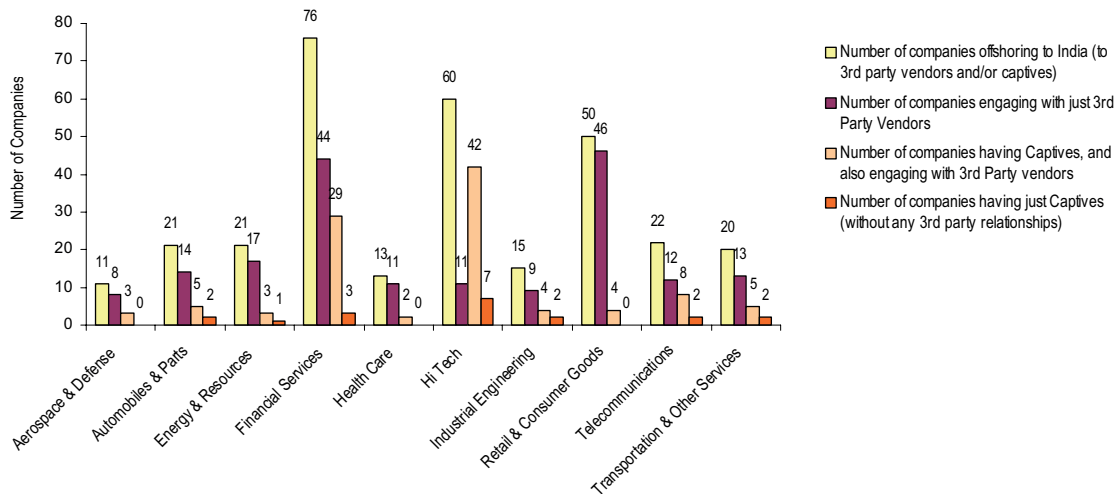


Figure 3: Industry verticals setting up captives in India

Source: Infosys Research

Companies in the Hi-Tech and Telecom verticals account for about 48% of all captives in India. Software and IT are often core to organizations in these verticals, and intellectual property (IP) related to software is a significant source of competitive advantage. Consequently, captives in these verticals help retain core activities. On the other hand, captives are not a preferred sourcing option in sectors where IT is a non-core activity, for example Retail & Consumer Goods and Energy & Resources. The research results are in line with Infosys' experience that the need to retain core activities while leveraging offshore locations is the primary driver for setting up captives.

Organizations in the Financial Services space account for 26% of the captives in India. While these organizations do not have technology as their core activity, they extensively leverage technology-based offerings as their unique selling proposition. They need to adhere to industry-specific information security and compliance norms, and typically, a large part of their IT and business process portfolios have direct customer impact. All of these factors influence their outsourcing strategies, leading many of them to keep work in-house. Here again, 91% of the financial services organizations with captives also engage with third-party service providers, outsourcing to them work which need not be confined within the organization.

Figure 4 depicts offshoring data for the various industries in China covered in our study.

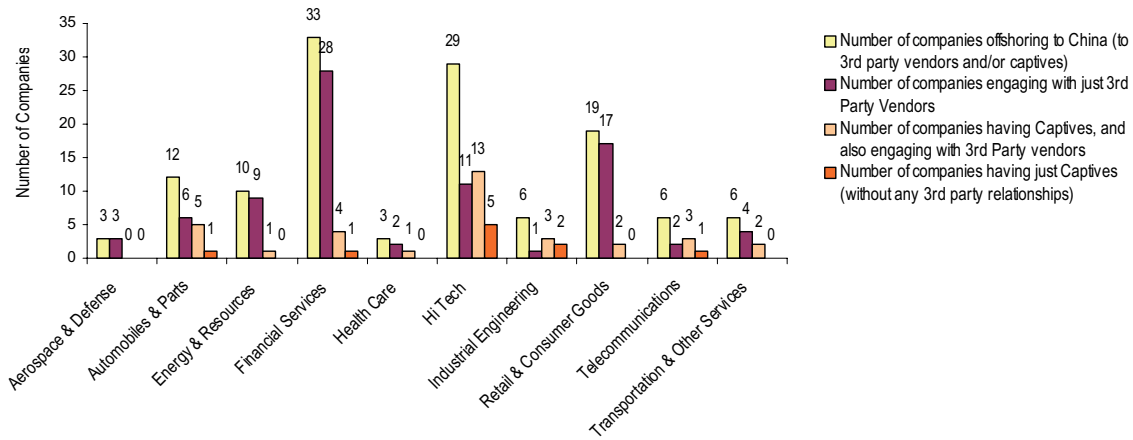


Figure 4: Industry verticals setting up captives in China

Source: Infosys Research

Given China's vast manufacturing capabilities, it can be expected that captives in China are predominantly related to manufacturing. Our research confirms this expectation: Hi-tech and telecommunication companies account for 50% of the total number of captives, with many focused on design services such as integrated chipset design. This is followed by automotive and industrial engineering organizations that account for 25% of the captives in China. Most of these organizations are located in proximity to manufacturing centers and offer engineering design services.

Outsourcing to India is strong in manufacturing-related industries, and much stronger in service-related industries such as Banking and Insurance. The distribution of captives in India and China shows India as a more mature location with multi-faceted and multi-industry capabilities. China is engaged primarily in areas of traditional strength – hi-tech and manufacturing. In the near future, China is likely to expand its capabilities. A few captives are already providing business process outsourcing (BPO) services in diverse industries such as Banking and Insurance and have the potential for continued growth. For example, in Shanghai, Unilever has a subsidiary offering supply chain management services, while American Express has a joint venture offering BPO services like travel ticket booking, and other customer service offerings. China has been scaling up to offer BPO and transaction processing services to organizations from the US and UK by working on overcoming the language barrier. It has also become a preferred outsourcing destination for countries such as Japan and South Korea due to its geographical proximity and availability of the required language skills in regions like Dalian.

Activities Undertaken in Captives

Captive centers can provide IT services, BPO services, or engineering design services for companies involved in manufacturing. Our research reveals that in India-based captive centers, IT services are the primary focus with over 71% of the captive units offering IT services. These services are in the area of application development and maintenance (ADM), infrastructure management, and enterprise solutions such as EAI, ERP and CRM. More recently, business process offshoring has gained ground, and with significant economies of scale to be realized, over 29% of the captive centers have taken up BPO along with IT. These centers typically combine voice-based offerings, transaction processing, and KPO services with IT. When compared with India, China is still a minor destination for IT-related activities such as ADM and infrastructure management.

Industry	India							Total
	Only IT	Only BPO	Only Eng.	IT & BPO	IT & Eng.	BPO & Eng.	All	
Aerospace & Defense			1		1		1	3
Automotive & Parts	2		1	1	1	1	1	7
Energy & Resources	2		2					4
Financial Services	6	12		14				32
Healthcare		1	1					2
Industrial Engineering	1		2		3			6
Hi-Tech	16	2	5	11	14	1		49
Retail & Consumer Goods	2					2		4
Telecom	1	2		2	3		2	10
Transportation & Other Services		2		4	1			7
TOTAL	30	19	12	32	23	4	4	124

Figure 5: Activities undertaken in Captive Units in India

Source: Infosys Research

India remains the preferred option for relocating business process related services from North America and Europe. These services are driven by language-related skills; China still has some way to go before matching the capabilities available in India. Our experience shows that Far East markets such as Korea and Japan can be serviced more effectively through China than from India. China is developing its capability to deliver business process services, and the first few BPO centers indicate the progress of China as a services sourcing center.

Industry	China							Total
	Only IT	Only BPO	Only Eng.	IT & BPO	IT & Eng.	BPO & Eng.	All	
Aerospace & Defense								0
Automotive & Parts			5				1	6
Energy & Resources			1					1
Financial Services		4			1			5
Healthcare			1					1
Industrial Engineering	4		5	4	3		2	18
Hi-Tech			1	1	1	2		5
Retail & Consumer Goods		2						2
Telecom	3	1						4
Transportation & Other Services		1		1				2
TOTAL	7	8	13	6	5	2	3	44

Figure 6: Activities undertaken in Captive Units in China

Source: Infosys Research

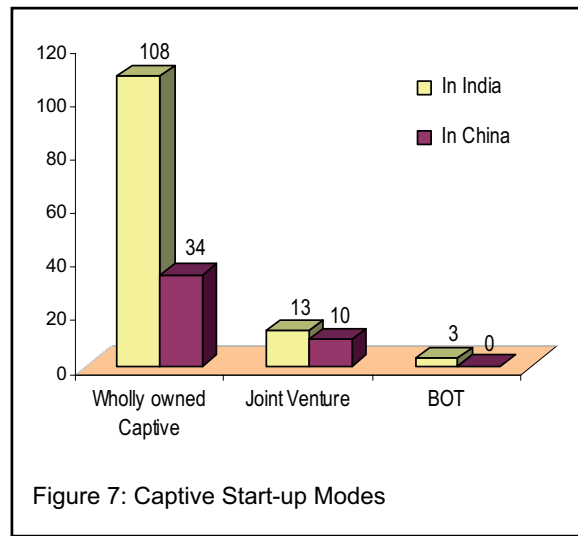
Captives in China, especially in the hi-tech and automotive sectors are focused on providing engineering-related services such as computer aided design and manufacturing. China, with its significant presence in manufacturing excels in engineering related services, whereas India provides talent in software development; and engineering services in India are primarily an add-on to software-related activities.

Clearly, the services being offshored to both India and China are dependent on the skill sets of their local labor pools. Companies have been grouping service lines as feasible to achieve economies of scale and to make optimum use of their resources.

Means of Setting up a Captive

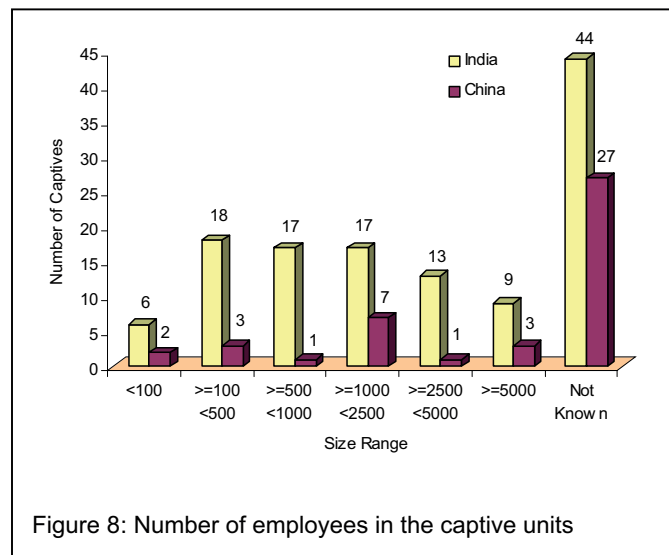
Companies looking to setup captives have alternative startup modes. The most common approach involves setting up a wholly owned subsidiary - almost 90% of India captives and more than 75% of China captives are set up through this approach. Other approaches involve setting up an equity partnership with a local entity (usually referred to as a Joint Venture or JV) or paying a local service provider to set up, start operations and transfer ownership to the parent organization after a certain duration (usually called Build Operate Transfer or BOT). In essence, these approaches help to share risks with a local partner and therefore ease the setting up and initiation of operations.

However, critical questions around flexibility, contracting, legal liabilities, and above all, employee morale remain. Our research suggests that the challenges with BOT and JV are daunting, accounting for the low incidence of companies opting for these models.



Source: Infosys Research

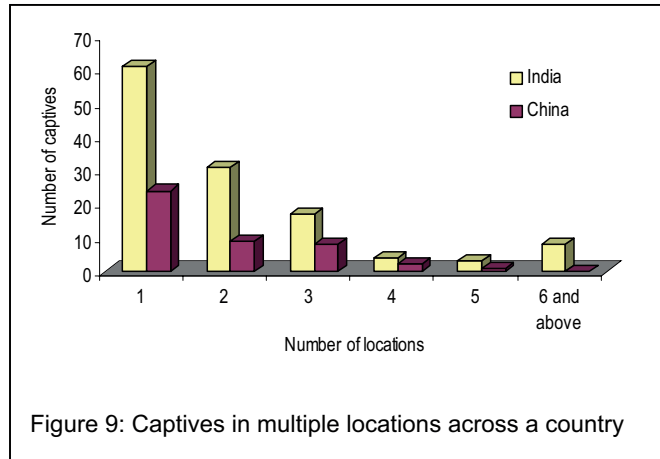
Scale and Location of Captive Units



Source: Infosys Research

A captive needs both scale and growth to survive. Without scale, captives struggle to reduce or even maintain costs, and attracting/retaining talent becomes extremely difficult in the absence of growth. We had some difficulty in obtaining the actual number of employees in many of the captives. The information we could gather indicates that a vast majority of captives in India and many in China are over 500 people strong. A year ago, this was not the case, indicating that many captives are growing – in order to reach economic scale and prevent the ‘Inverted Pyramid’ syndrome.

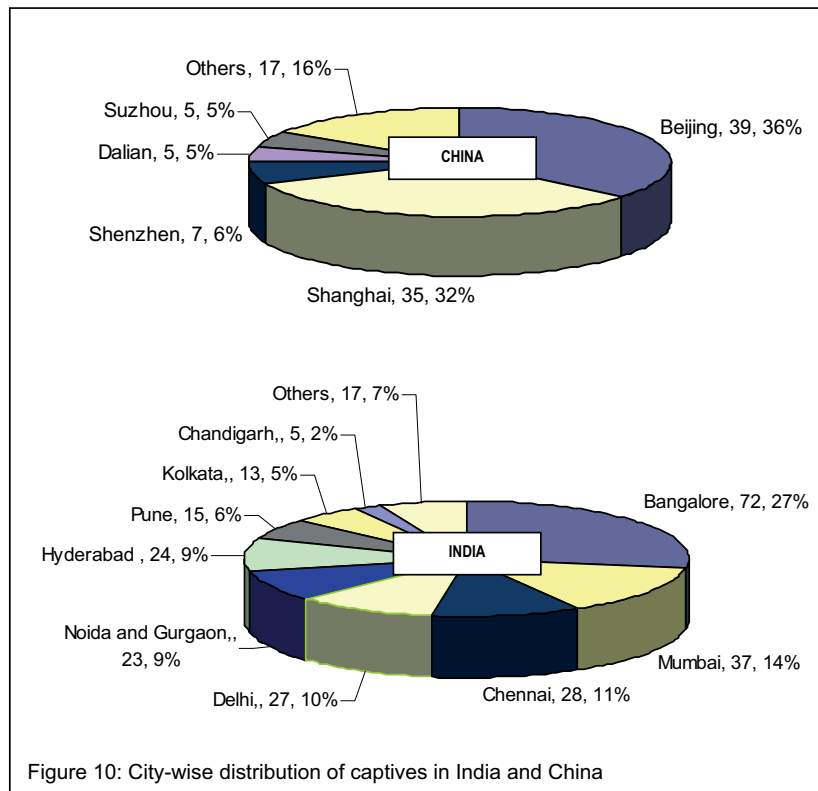
Captives in the 'Not Known' category are likely to be small captives.



Source: Infosys Research

For reasons of scale, most companies that have set up captives in India or China operate out of a single center – as evinced in Figure 9. Such single location operations help consolidate support services and ease coordination, but they increase risks related to business continuity and disaster recovery. As against findings from our research done last year, today there are more companies with captive centers in two or more cities.

Captives are usually concentrated in cities that offer the best infrastructure, business environment and access to talent. Our research indicates that Bangalore, Delhi and the National Capital Region (consisting of Noida and Gurgaon), Mumbai, and Chennai are the main hubs for captives in India, while Shanghai and Beijing are the main hubs in China. Special requirements around language or skill sets can dictate the choice of location. For example, Dalian and Chennai are emerging as hubs for automotive industries, while Mumbai and Shanghai have a greater concentration of captives in the financial services space.



Source: Infosys Research

Sourcing Strategy Incorporating a Captive

Captives need to be supplemented with third-party relationships. By themselves, captives usually do not prove cost competitive, and often cannot provide good access to talent because they need to operate from a few locations only. Furthermore, in areas where data security, control or IP creation and protection are not important issues, third-party vendors can provide much better capabilities.

Organization need to adopt a balanced sourcing strategy that provides the basis for deciding what gets done in a captive, and what is best left to third-party vendors. Our research indicates that sourcing strategies are maturing rapidly. As illustrated in Figure 2, only 6% of the companies researched in India depend exclusively on their captive (the corresponding figure for China being 8%), while others use only third-party service providers or a combination of service providers and captive units. The choice of approach requires mechanisms for a thorough assessment of activities to match them with sourcing objectives, and arrive at best-of-breed ownership and responsibilities.

Our experience indicates that captives often take up activities they are ill-equipped to handle, in order to attain the scale required for them to reach economic viability. Apart from affecting the quality of service, this lopsided allotment jeopardizes existing vendor relationships. A typical captive operates as part of a sourcing ecosystem rather than as an isolated entity. This ecosystem consists of a company's captive, offshore development centers with third-party vendor(s), and onsite delivery centers operated by the company. Companies must decide on how these parts operate together to ensure success of their offshoring initiatives.

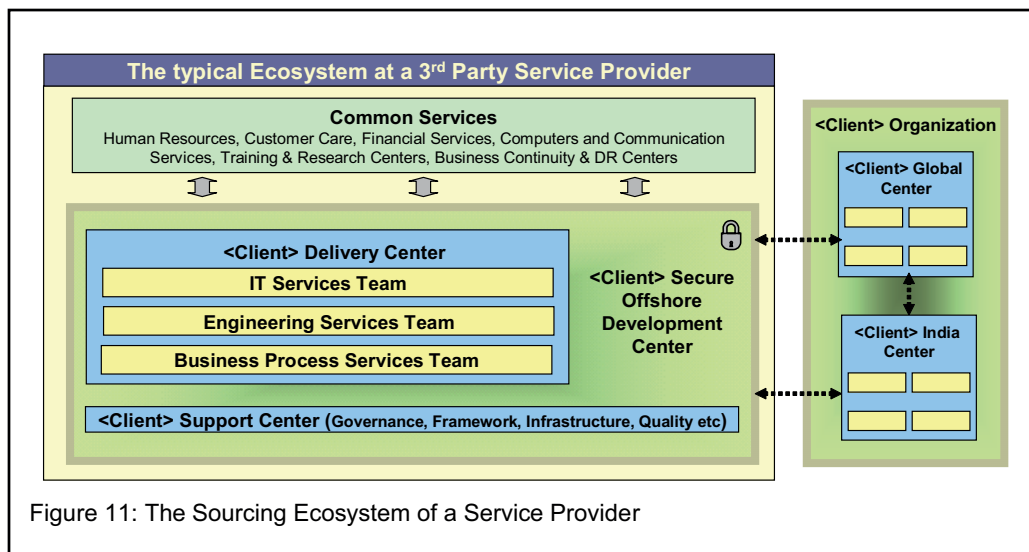


Figure 11: The Sourcing Ecosystem of a Service Provider

Source: Infosys SGS Group

As illustrated in Figure 11, the typical ecosystem of a service provider consists of a secure offshore development center (ODC) created for executing specific outsourced services for the client through a delivery center, a support center handling governance (processes, management and metrics), frameworks (architectures, methods and tools), infrastructure (licensing and security), quality, knowledge management, and reusability. The entire ODC is secured from the rest of the organization, the only contact points being common services such as recruitment, training, research, technical support, and disaster recovery.

This offering, combined with third-party providers' ability to rigorously conform to a client's existing processes and way of working and their increasing willingness to consider alternative contractual models, has made total organization-wide offshoring to services providers an attractive possibility.

Our research shows that at least five captive centers have closed shop in India in the last year due to inadequate planning and process immaturities – with three of them continuing their relationships with third-party service providers. Exiting captive centers can be a costly process resulting in business continuity disruption and financial losses, not to mention the public relationship impact.

Conclusion

Organizations looking to take the captive route for meeting their offshoring needs must ask themselves the following key questions:

- Are we planning to offshore our mission-critical functions?
- Is our management committed to investing time and attention to set up and oversee the captive's operations?
- Will our offshore facility attain the scale needed for it to be cost-effective?
- If our brand's awareness is low in India/China, can we commit large budgets for public relations, marketing and human resource management?
- Can we successfully compete for talent against established domestic players?
- Can we afford the longer time-to-market, higher investments, and delayed ROI that are typical of captives?
- Are we equipped to deal with the local bureaucracy; legal, taxation and labor regulations; and cultural differences in India and China?

Only upon getting positive responses to these questions can organizations confidently venture into establishing their captive centers. Even then, as indicated by the co-existence route chosen by most organizations included in our study, it would be best to liaise with established third-party providers who can support their initiatives. Indian service providers have risen in their capabilities along with their experience and now possess the ability to assess the offshoring maturity levels of other organizations. Service providers are increasingly engaging with clients to understand their existing portfolio and help them arrive at the optimal work allocation mix between captive and secure offshore development centers.

As the commonly heard refrain goes, "Captives are here to stay!" But instead of going at it alone, co-existence must be the mantra for attaining offshoring success in the ever-flattening world

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