

Research



Captives in India: A Research Study

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Captive centers are being used by a number of players for offshoring work to India primarily for control over assets, intellectual property and core business activities. To understand the evolution of captives in India, Infosys conducted a study covering large companies across various industries. The results indicate a highly competitive space dominated by a few, very large centers and populated with a large number of recent entrants. Most captives in India are planning strong growth, but important questions remain over the future of a vast majority of small new captives that are trying to scale up alongside much larger competitors. Infosys' research underscores the need for a strategic approach to captives. A clear definition of the activities to be delivered by the captive unit, its size, as well as its understanding of the strategic importance of offshore operations, are key factors for success.

IT and Business Process Captives in India

India has become a global hub for IT and business process offshoring. For the most part, offshoring to India had been associated with outsourcing to Indian services companies. However, captive offshoring, which is offshoring without outsourcing of IT and business services, is on the rise. This paper is a result of a recent study undertaken by Infosys, where we researched large European and North American companies to determine whether they had a captive, or were planning to set up one, in India. Further, for companies that had a captive in India, we researched basic information such as location, date of inception, method of creation, functions and activities undertaken, size, growth and future plans.

Researching captives is a difficult task due to the proliferation of operating models in this high-growth environment. Infosys' research indicates that existing captives plan a 50% (or more) rise in their strength over the next year. In addition, a number of new captives are in the pipeline. Clearly, there has been explosive growth in the last few years, which may be carried over in the near future. This alone makes it difficult to accurately gather simple information such as size, growth and plans for a captive. To add complexity, many captives handle multiple activities from several locations, often by deploying vendor employees in addition to their own. Further, unlike service providers, who often guarantee performance through Service Level Agreements (SLAs) and other contractual commitments, captives are completely at the mercy of on-ground realities such as spiraling attrition, talent deficit, rising costs and need for scale. The intent in setting up a captive is often at variance from ground realities, which makes it hard to determine what a captive is actually doing.

Nevertheless, we felt the need to obtain some important parameters related to captives in order to understand the space. We studied a sample of 250 companies drawn from the FTSE 100 and Fortune 500 lists, in six industry verticals:

- Financial Services
- IT and Software
- Hi-Tech Manufacturing
- Automotive, Aerospace and Machinery
- Telecom
- Retail, FMCG and Apparel

The study helped us gather insights on:

1	Industry verticals setting up captives
2	Chronological distribution of captives
3	Size of captives
4	Activities undertaken in captives
5	Location of captives
6	Method of creation of captives
7	Growth of captives

These aspects are discussed in detail below.

1. Industry Verticals Setting Up Captives in India

A large number of companies have already set up captives in India. Of the 250 companies researched by Infosys, about a third (or 80 companies) had one or more captive centers. These companies were dispersed across the various verticals (Figure 1) studied: Financial Services, IT/ Software, Hi-Technology, Retail, Telecom, Automotive, Aviation, Industrial Goods, Consumer Durables and Electronics. However, three verticals clearly dominate the scene: IT/ Software companies, Hi-Tech manufacturers and Financial Services firms.

In the Software and IT Services vertical, large American software firms are clear leaders. Companies such as Microsoft, Oracle and IBM have had a presence in India for quite some time as the region is a strategically important source for talent. Of course, European firms such as SAP also have captives in India, but they are far outnumbered by American firms. The reason for this dominance is twofold – first, US IT firms outnumber European IT firms. Second, a very high percentage (almost two-thirds) of American firms have set up captives in India.

Industry	America Captive/Total (%)	Europe	Total
Financial Services	11/60 (18%)	9/21 (43%)	20/81 (25%)
Software and IT Services	23/36 (64%)	0/2 (0%)	23/38 (61%)
Hi Tech	13/24 (54%)	2/2 (100%)	15/26 (58%)
Auto, Aero and Machinery	8/35 (23%)	1/10 (10%)	9/45 (20%)
Telecom	2/18 (11%)	5/12 (42%)	7/30 (23%)
Retail, FMCG and Apparel	2/5 (40%)	2/13 (15%)	4/18 (22%)
Others	1/5 (20%)	2/3 (66%)	3/8 (38%)
Total	60/183 (33%)	21/63 (33%)	81/246 (33%)

Figure 1: Industry Vertical Distribution of Captives

Source: Infosys Research

The situation in Hi-Tech manufacturing and design companies is identical to that of IT and Software. Companies such as Cisco, Motorola, Dell, Applied Materials and Intel have a strong presence in India and they have been here for over five years – a substantial length of time in this space.

Interestingly, while in the overall context, companies from Europe and America are equally likely to set up captives in India, in the Financial Services domain, European firms are more inclined to captives. Similarly, in the Telecom domain, European firms such as Nokia, Ericsson, Alcatel, BT and Siemens have been much more active in setting up captives when compared to US firms.

European captives could be a reflection of conservative intellectual property management, data ownership or people management practices in Europe, which prevent outsourcing (but not offshoring) of work, despite the higher financial risk of setting up a captive. However, in our experience, it is more likely that American firms have been slower of the blocks due to more stringent norms for offshoring data (rather than outsourcing it, because American financial services and telecom firms work extensively with external vendors).

In summary, American financial services firms seem to have taken a more conservative financial approach by outsourcing, even though it involves sharing intellectual property with vendors. European firms have taken greater risks in setting up captives, but they have faced fewer issues on data security.

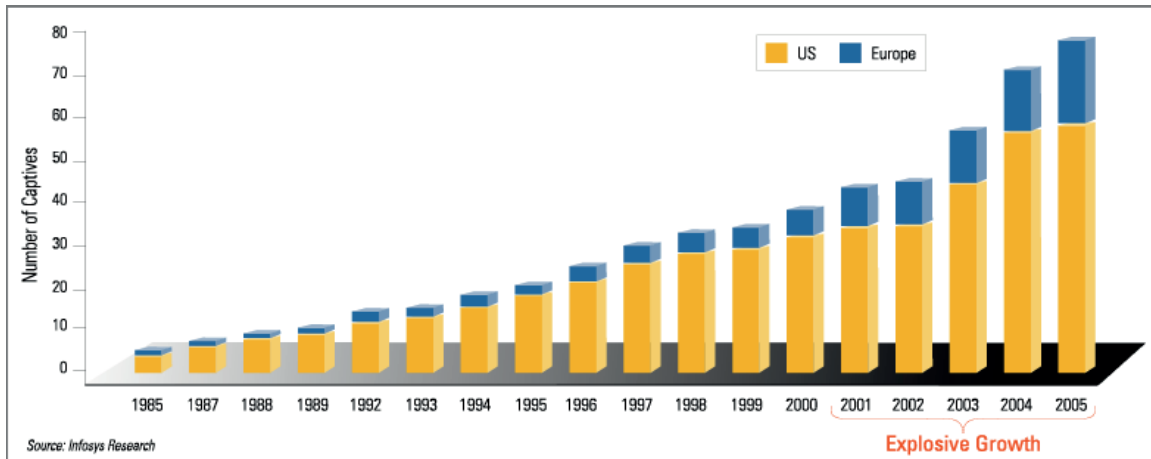


Figure 2: Chronological Distribution of Captives

2. Industry Verticals Setting Up Captives in India

The number of companies setting up captives in India is growing rapidly. Almost 40 of the 80 companies in India were set up in the last five years compared to 20 in the preceding six-year period (1995-2000).

This growth represents both increased interest from traditional offshoring industries such as IT and Hi-Tech manufacturing and interest from new offshoring industries such as Financial Services, Telecom, and more recently, Retail.

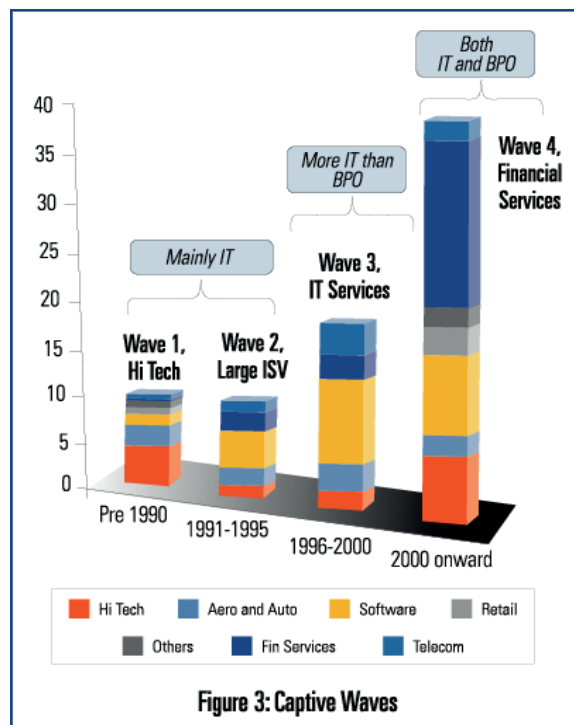


Figure 3: Captive Waves

Source: Infosys Research

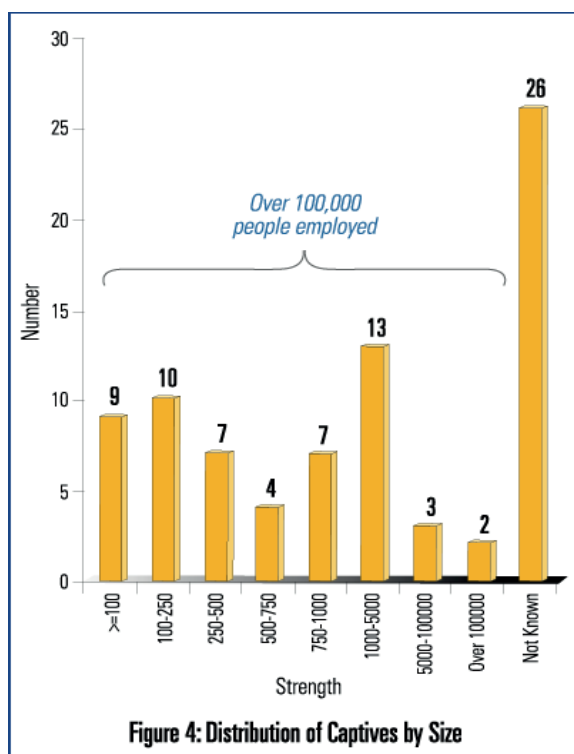
A deeper analysis of the chronological and industry vertical distribution of companies shows that captives were established in India in four waves (Figure 3). The first wave consisted of ten captives set up by Hi-Tech manufacturers such as HP, Motorola, TI and Lucent. These captives were focused on research and development activities. The second wave consisted of ten captives by large software firms such as Siemens, IBM and Oracle. They set up between 1991 and 1995 and were focused on software development.

The third wave consisted of 20 captives of Hi-Tech and IT services! software firms: Microsoft, Unisys, Perot Systems, EDS and Apple, which arrived between 1995 and 2001. The final wave, ongoing since 2001, already consists of 16 financial services and 15 IT services and Hi-Tech firms.

These waves are indicative of India's growth capabilities in services. Initially, captives were restricted to IT and software. More recently, they are coming for business services in addition to IT and software capabilities.

3. Size of Captives

The average size of a captive currently is about 1,000 persons per company. However, the median size is 375. Less than ten companies employ 5,000 persons or more, about 20 employ more than 1,000 persons. Over 60 captives were below 1,000 people in size, some as small as 100 persons or less (assuming that captives where the size is not known would have very few employees - since the larger captives would invariably declare the size) (Figure 4).



Source: Infosys Research

The issue of captive size is important because smaller sized captives are usually uneconomical to maintain. They also cannot offer employees long-term career growth and therefore face high attrition. Some very small-sized captives continue to exist because they support work that is so specialized that employees justify higher cost by producing very high value and look to global career prospects. However, for most captives, scale is crucial - both for retaining employees and managing costs.

Thus, innovative solutions have been tried in the search for scale. For instance, some captives have hosted vendor employees in order to improve capacity utilization. Some have pressured parent organizations to revert all third-party work to them. Some others have increased size in the hope that the pressure of supply will create demand. However, these are short-term solutions because they are sub-optimal from an overall business point of view and do not address the basic question of where a captive can add value and, therefore, what activities it should be undertaking. The main approach adopted for better scale is to raise the value proposition of a captive by expanding the type of activities done at a center.

4. Activities Undertaken in Captives

Undertaking multifarious activities under a single captive center provides significant economies of scale because similar underlying infrastructure is required for most IT and business process offshoring activities (Figure 5).

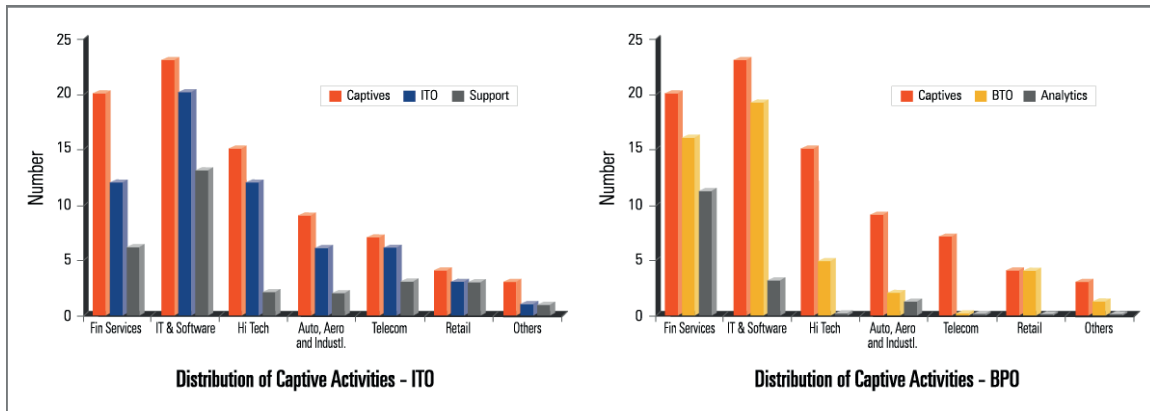


Figure 5: Distribution of Captives by Activities Undertaken

Source: Infosys Research

Not surprisingly, 60 of the 80 captives in India offer both IT and BPO services. The desire for taking up more work in a captive is relentless (Figure 6).

Industry	Only ITO	Only BPO	Only Eng.	Both ITO & BPO	Both ITO & Eng.	Both BTO & Eng.	All 3	Total
Financial Services	4	8	-	7	-	-	1	20
Software and IT Services	4	3	-	16	-	-	-	23
Hi Tech	4	-	2	2	4	1	2	15
Auto, Aero and Machinery	-	-	3	1	4	-	1	9
Telecom	5	-	1	-	1	-	-	7
Retail, FMCG and Apparel	-	1	-	3	-	-	-	4
Others	-	-	2	1	-	-	-	3
Total	17	12	8	30	9	1	4	81

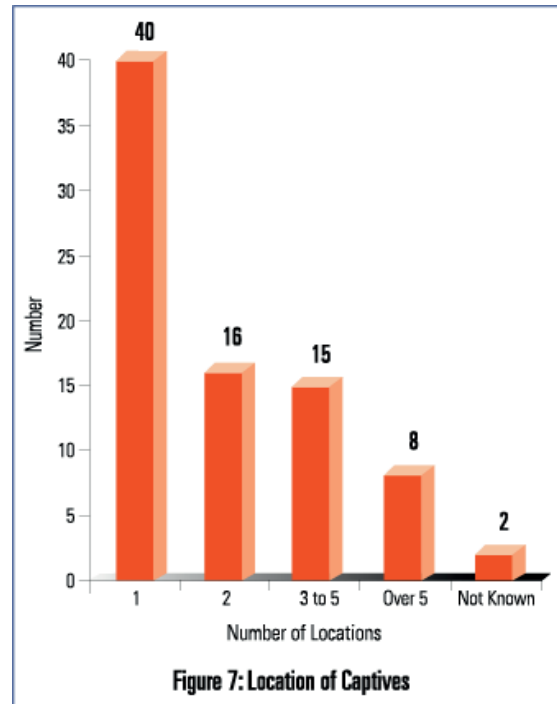
Figure 6: Overlap in Activities Undertaken by Captives

Source: Infosys Research

For instance, IT outsourcing centers that previously covered application development and maintenance and software development have now expanded to provide network and data center management, desktop management and even help desk support. Within BPO, all centers that provide voice now combine non-voice operations. Voice operations traditionally covered help desk and customer support, but now they include telemarketing and telephone based consumer research. Non-voice services now include customer analytics and business research.

5. Location of Captives

Almost half the companies covered in the study operate from a single location and another 20% operate in two cities. Only the biggest players operate in three or more cities (Figure 7). Inability to increase the number of centers is a problem because captives need to access second-rung cities in India to tap more talent, avoid attrition and circumvent stifling infrastructure bottlenecks. Companies that cannot tap second-rung towns for talent risk higher costs. But, at the same time, companies that maintain multiple centers need to scale to make each of these centers viable.

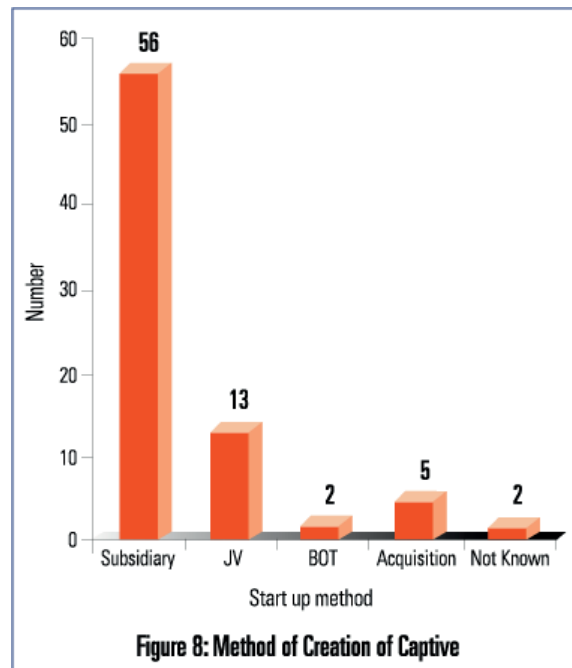


Source: Infosys Research

Bangalore is the undisputed leading location for captives in both IT and BPO. As per our study, it hosted twice the number of centers as its nearest competitors. Delhi (including adjacent towns and the NCR region), Mumbai, Hyderabad and Chennai are next and each of them host roughly half the number of centers in Bangalore. Pune and Kolkata are at the third place and they host about a fifth the number of centers in Bangalore. Infant locations that are just getting their first few centers are Chandigarh, Vizag, Lucknow, Kochi, Jaipur, Mangalore, Nagpur and Mysore.

6. Method of Creation of Captives

Despite considerable discussion around innovative ownership models, research indicates that wholly owned subsidiaries are the main route for setting up captive operations. Almost 70% of companies that have set up captives have done so through wholly owned subsidiaries. In addition, five companies obtained captives through the acquisition of the Indian entity's parent (Figure 8).



More innovative models, which involve a financial or operational partnership with established Indian entities for setting up a captive, are not popular. Only 13 players (16% of the 81 companies that have captive) set up joint ventures in conjunction with established Indian players. Build-Operate- Transfer (BOT) deals are few and rarely invoked. Clearly, notwithstanding the interest in BOT, the transfer part of this model has rarely been used on the ground to establish an owned unit.

7. Growth of Captives

Most captives are recruiting heavily in anticipation of demand. An overwhelming majority (over 90%) of existing captives are planning to grow headcount at 50% per annum or more for the next few years. As captives are increasing the scope of their activities, they may be able to address a larger pool of talent; but the larger picture remains the same: they will compete head on with (a) top Indian service providers, which are themselves looking to grow at 40-50% per year and (b) with gigantic captives, which are at a scale similar to Indian tier-2 vendors and also looking to grow over 50% a year. Consequently, while hiring in large numbers seems to be a common desire, it is more than likely that a war for talent will result in severe wage inflation in the foreseeable future.

Conclusion

Captives have an important role to play in offshoring. Understandably, many companies are using captives to preserve control and protect intellectual property. At a very large scale of operation, captives may even provide lower costs than the price charged by vendors. These are powerful incentives for setting up a center in India. As a result, our research shows that the number of captives being set up in India and their size are both increasing rapidly.

Nevertheless, there are immense risks. The IT and business process industry is in a state of explosive expansion primarily because economies of scale are vital. Those who have set up are compelled to grow simply to manage attrition and control costs. Those that are yet to come in or have not achieved scale, risk being severely squeezed in a rush for size.

Infosys' research, like numerous other studies, has clearly pointed to an imminent paucity of talent and infrastructure over the next five years. If current business plans are implemented, the number of captives in India will have more than doubled and the average size of captives will have more than quadrupled in the next five years. All things considered, there is only limited space for the IT and business process industry: ten cities which are capable of hosting captive centers, 700,000 people currently employed by IT and business process offshoring to India and three industry verticals (IT and software, Hi-Tech Manufacturing and Financial Services) that account for most captives.

In the current environment, a captive center needs great commitment. Therefore, companies must align their view on captives with their sourcing strategy before committing to a course of action. In our opinion, this alignment necessarily involves a decision on what must be kept in house and what can be outsourced and a separate assessment of the best location for a particular activity. These assessments, at the very least, require a careful study of business processes, application portfolios, market environment, management thinking and overall business strategy. The time for muddling through after starting a captive is forever consigned to history.

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