BUSINESS INSIGHT

Organization

Four Strategies for Offshore 'Captive' Centers

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The global business environment is a fast-moving one, and it requires large companies to adapt quickly. So-called captive centers offer a striking example of this truism.

Captive centers are overseas subsidiaries set up by global corporations to serve the parent company. They are an alternative to contracting out jobs to an offshore provider.

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Many multinational companies set up captive centers in India in the mid-1990s, farming out tasks such as software maintenance and customer support. In recent years, however, many have switched strategies for managing these businesses. Some companies, for instance, decided to sell their captive center's services to outside customers -- in addition to using the services for their own needs -- while others outsourced noncore tasks to Indian vendors to reduce costs. Still others sold majority stakes in their captive centers to improve the firm's operations and financials.

We looked at 150 of the largest global companies and found that 80 have, or had, captive centers in India. Of those 80 companies, 30% changed their strategy for managing their captive centers in the past six years, some more than once. We found four major ways in which companies deviated from the basic captive-center approach.

Here is a look at each of the strategies -- as well as their opportunities and risks.

THE HYBRID CAPTIVE: The hybrid captive is one that continues to perform core business processes for the parent company, but outsources noncore work -- say human-resources tasks -- to a vendor in the offshore location. Ten of the 80 companies in our sample, or 12.5%, adopted this strategy.

By farming out noncore tasks, the captive center can invest more time and money in higher-profile work, as well as cut costs. Local vendors are generally cheaper than a captive center because their people model is leaner and overhead lower, according to a study from Everest Research Institute, an independent research and analysis organization in Dallas. The downside is that the projects being outsourced often involve small budgets and repetitive work, so they are of low priority to vendors and usually suffer from high staff turnover. This may result in vendors assigning inexperienced workers to the projects and failing to invest in procedures designed to capture and retain client knowledge, which can create frustration and disappointment on the client side.

A hybrid captive also must be capable of managing relationships with vendors, meaning it has to develop management skills usually provided by the parent company.

THE SHARED CAPTIVE: This type of captive center performs work for both its parent company and external customers. It is used by companies seeking to expand their business from the offshore location. Nine companies in our sample -- 11% -- adopted this approach.

A shared captive usually becomes more efficient and valuable because it uses existing offshore assets for multiple projects. As the volume of work increases, the cost per unit of work performed goes down, making the business possibly more attractive to potential buyers in the event of a sale.

Among the challenges: If competition for customers is driven by cost, local vendors may have an advantage. Therefore, shared captives should look for clients internationally, not just in the offshore location.

THE DIVESTED CAPTIVE: This is an opportunity to exit an investment made in a captive center, usually to strengthen a firm's balance sheet or raise capital to invest in the business. Five companies in our sample -- 6.3% -- chose this route.

The captive centers that stand the best chance of being sold for a profit are those that have pursued a shared strategy first. They will have the scale and scope to attract potential buyers, in particular local vendors seeking to grow and enter new markets.

THE TERMINATED CAPTIVE: Seven firms in our sample -- 8.8% -- terminated their captive operations, typically because subpar service was hurting the parent company's reputation.

A company can minimize losses incurred when it shuts down a captive center by outsourcing less-critical parts of the business to vendors in the offshore location and moving critical components back onshore, where they can be managed and fixed more easily.

When deciding which captive-center strategy to pursue, managers should ask themselves two questions:

Is the move offshore aimed at growth or cost savings? And is the offshore market developed or underdeveloped?

If the local market is developed and the strategic intent is cost savings, we advise increasing a captive center's scale and then divesting the business for profit. If the strategic intent is growth, we suggest seeking out international clients and investing to improve operations. If the offshore market is underdeveloped, it may be best to use the captive center only for the parent company's needs or to pursue a hybrid strategy.

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