

Beyond Cost Reduction: The Risks and Rewards of Global Services Sourcing



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EXECUTIVE SUMMARY

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Some years back, Global Services Sourcing (GSS)¹ was garnering anecdotal coverage in the media as a novel way for some businesses to generate cost reductions. As the phenomenon has gained momentum, it has polarized both experts and the public into “for” or “against” positions. Managers have been exposed to a steady diet of anecdotes and rhetoric on how offshoring affects employment, customer service quality and costs. From the perspective of business strategy, these accounts leave a number of questions unanswered: What is the totality of risks and rewards that offshoring offers today? How is this landscape evolving? What areas are more or less advanced? What are best practices in the design and implementation of offshoring? What learnings have the pioneers accumulated along the way, and what models have they developed to maximize the impact of their offshore operations at a global level? These questions have enormous strategic and financial implications for businesses, and yet are not presently understood in any comprehensive and rigorous manner.

Objective

Our objective in this report is to offer a pragmatic and fact-based perspective on these questions. Rather than painting the rapidly evolving offshoring landscape in broad brushstrokes, our report pinpoints one sector – Financial Services – and investigates the dynamics of offshoring in this industry as viewed along three segments – Venture Capital & Private Equity, Retail Banking, and Institutional Banking. We selected this sector given the substantial size of the industry and the active interest, whether or not acknowledged in the public domain, that financial institutions have taken in offshoring.

¹ Our focus is on business processes that are being sourced on a global basis (whether accomplished via an internal team or a third party) – i.e., beyond US shores. We use the term “offshoring” interchangeably with GSS.

Key findings

1. Wide-ranging levels of adoption and awareness

Offshoring within financial services has moved beyond the early adopters and has entered the rapid growth phase of its adoption cycle. That said, it is far from reaching maturity. Different companies – and in fact, different industry segments – are at different stages of adoption. And while offshoring is now a standard practice for certain business processes, it is still at an experimental stage with other processes.

Among industry segments, the VC (venture capital) community is by far the leading adopter. This can be attributed to their technology focus, which led them to get an early taste for offshoring in the '90s through IT initiatives. In recent years, the increased pressure faced by VCs to make better use of capital – translating into the need for reducing burn rates of portfolio companies and getting startups to achieve key milestones at reduced investment levels – has led them to aggressively grow the offshoring model organization-wide.

The Retail Banking segment comes next in its level of adoption. Given their low margins and large scale of operations, these institutions have a lot to gain from small percentage improvements in operating costs. But this same scale means that there are significant challenges as offshoring is put into high gear - from a pilot to a full-scale operation.

Institutional Banks and PE (Private Equity) firms have historically been more cautious about entering the offshoring arena. In the case of Institutional Banks, their business processes are typically low volume, high skill – given the high end nature of their work and client relationships. Consequently, offshoring entails significant risk, and, at best, requires a major investment in training. PE firms have lagged VCs in their interest in offshoring given their conservative business models and their more limited international and IT exposure. The last 12-24 months have witnessed acceleration in PE activity in this area, as offshoring success stories in the PE community have highlighted the latent

potential of this model as a lever that can both be applied to improve the financial performance of portfolio companies and can be used to identify investment opportunities with significant potential for value creation.

2. Offshoring respects few boundaries

Conventional wisdom will say that you should outsource “low-end” functions that are simple and low-risk. And this is certainly true when one looks at the origins of offshoring in financial services –operations that were initially offshored include call centers and back-office finance & accounting work. The landscape is starting to shift substantially as firms grasp the full potential of the talent pool they have access to in offshore locations. In recent times, a number of examples can be identified of firms tapping offshore teams for “high-end” processes that are complex and high-risk. Higher upfront investment in training and process design is typically required. And the benefit may only incidentally involve lowering of costs – often, offshoring gives firms the ability to perform complex assignments that may otherwise have never been executed. As offshoring takes on these new frontiers, one thing is certain – we have only a limited, though dynamically evolving, view today of offshoring’s ultimate scope and its consequent risks and rewards.

3. Service providers – Offshoring experts, by default

You don’t want a car salesman to tell you which car to buy without doing your own research and talking to other car owners. But that is precisely the situation with offshoring today. Companies are not comfortable disclosing their offshoring activities – and this has led to an absence of benchmarks, case studies, and shared best practices and consequently, to instances where businesses are reinventing the wheel. A few consulting firms and, more often, the global sourcing service providers, are the industry experts. To continue the car buying analogy – the industry is ripe for services such as JD Powers, Consumer Reports and Epinions – where offshoring players and practices are evaluated and ranked by objective third parties or customers.

4. Proof of concept is not proof enough

Leading adopters of offshoring have developed a good understanding of how to launch offshore operations. But if you're looking at a pilot to give you reliable data on the full-scale performance of your offshore operations, beware. As operations are ramped up, a number of additional factors that affect performance come into play – such as the pace at which the offshore organization can be grown and the training and supervision of frontline staff. As a result, early results may hide more than they reveal, and significant execution issues may need to be addressed via a well-paced ramp up plan.

5. The palatable cost of cost saving

Skeptics have warned that offshoring will erode the quality of customer service, particularly at customer touchpoints like call centers, while adopters and service providers have steadfastly maintained that they are able to maintain quality as they transition operations to offshore locations. Who is correct? Our research shows indicates that the answer may lie somewhere between these two positions. Companies are finding that they have to make a “pact with the devil” – by accepting a perceptible, though typically small, drop in service quality as they scale their offshoring operation in the face of compelling economic benefits.

6. Offshoring's unintended consequence – “the multiplier effect”

Some advanced practitioners find themselves able to achieve a significant multiplier effect in capturing the benefits of offshoring by leveraging offshore expertise and resources to unleash a number of organization-wide initiatives, such as standardization of processes, and codification & global dissemination of best practices – thus driving operational improvements at a global level. The kernel of these multiplier effects is the development of a "high-end" offshore team that can innovate and improve on operational design and ultimately operate at a global level in deploying best practices.

7. Shortcuts to data security can short circuit the offshoring decision

The issue of data security at offshore locations is becoming increasingly important as the sophistication of work performed at offshore locations increases, especially in the context of tighter regulations (e.g. Health Insurance Portability and Accountability Act – HIPAA and Sarbanes Oxley). Data security concerns are also accentuated by isolated – but well publicized – cases of fraud such as a recent episode with a major bank. Companies cannot view data security as an afterthought; it has to be a front and center topic of discussion and needs to be work its way into the Service Level Agreements (SLA’s). This will mean forgoing some of the cost savings, but companies cannot afford to be caught on the wrong side of the fence on security issues.

8. Attrition can spoil the party

The headline from offshore service centers is “Attrition hurts!” Employee retention has been under siege in the major offshoring centers given the searing pace of growth in the industry and the intense competition for the limited pool of experienced personnel. Companies that have managed to stem the flow are those that manage their offshore teams at par with global teams and not an “also-ran”. Clearly defined career paths and training programs for offshore employees are becoming essential to the development of a sustainable and scalable offshore organization.

Methodology

Our fact base was developed via interviews with players across the industry – both financial institutions and offshore service providers. We supplemented this primary research with secondary sources of information, such as press articles and analyst reports.

Our dialogues with industry players made it evident to us that there is, within the retail and institutional segments, a keen interest among managers for cross-competitor benchmarks and best practices that have not been adequately codified to date. Most large

players are highly sensitive about discussing their involvement with offshoring – typically not because of competitive concerns but due to a heightened sensitivity to having their organizations publicly associated with this controversial trend.

Our conclusion is that this sensitivity – while well founded, given the proliferation of media accounts linking offshoring with layoffs and shoddy customer service – is hindering the pace at which industry players are able to learn and fine tune their offshoring strategies and practices. To help further this cross-competitor learning, our research identified and investigated a selected set of offshoring initiatives in depth, and these are documented in this report as sanitized case studies. While they do not yield a representative, “average” view of the state of the industry, they do serve as an illuminating catalog of offshoring successes, challenges and learnings.

Dynamics of offshoring

We emphasize in this report the use of a dynamic viewpoint in understanding offshoring. Any static portrayal of this area would hide more than it would reveal, for two reasons: one, the industry is evolving continuously and rapidly, having already moved through two or three distinct phases of development, and two, different players are at different stages of understanding and adoption, both at the segment and the institution level. To that end, this report lays out the timeline by which different segments have adopted offshoring. It also identifies the factors (“early triggers”) that initially triggered an interest in offshoring, by sector, and the factors that are fueling ongoing growth (“growth drivers”). Finally, one of the case studies presents a fascinating in-depth account of a retail institution’s bumpy ride on the offshoring trail and the ultimate equilibrium it has established between the risks and rewards of global services sourcing.

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In her role as Research Assistant, Ms. Usha Ramanathan, graduate student at the School of International & Policy Affairs, Columbia University, played a valuable role in building our fact base and defining our findings. She was the consummate team player, often taking initiative and investing time beyond the typical Research Assistant role to map out the offshoring universe through media research, interviews and conferences.

A number of executives in the Retail and Institutional Banking sector contributed to our work via one-on-one interviews. While they will go unnamed here given their interest in keeping their organization's identities confidential, their inputs have been instrumental in

shaping our understanding of the impact of offshoring on the Financial Services industry. They were also major contributors to the case studies we have crafted in this report.

We similarly received valuable inputs from executives in the Venture Capital/ Private Equity arena via one-on-one interviews. These include Vik Raina from Boston Ventures, Vivek Mehra from August Capital partners, Rishi Navani from WestBridge Capital Partners, Tom Rooney from Chesapeake Group, Carl Everett from Accel Partners, Dhimant Bhiyani from INC3 and Ash Lilani from Silicon Valley Bank. These individuals have, as well, been instrumental in shaping our understanding and developing our case studies.

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We have actively communicated with business journalists who cover offshoring. Pete Engradio from Business Week, Matthew Shaheen from VC Journal, and Prosenjit Dutta from Business World pointed us to relevant media coverage of this industry and helped direct our investigations toward emerging areas of offshoring.

Section A: Venture Capital /Private Equity

INTRODUCTION

Offshoring could not have come at a better time for the VC industry. With the technology sector under siege after the stock market correction in 2001, VCs have been seeking new models of investment that provide safer returns even as the markets take a more restricted view of technology stocks. There is broad recognition that offshoring is a critical driver in getting them there – both to improve the financials of existing investments and to facilitate new investments in startups that leverage offshoring from the onset.

As a result, the VC industry is at the leading edge of the adopting of offshoring as part of their investing strategies. For startups in certain industries offshoring has become a “must-have” in the VC portfolio toolkit. Since the bust of the dot com bubble, the new mantra for VC firms in the Valley seems to be “capital efficiency.” The “build them and they will come” mentality has been replaced by “watch what you build and how you build it”. VC firms across the board are pushing in that direction and offshoring is a means to that end. VC’s want to inject the “keep costs down” mentality from the start thereby increasing capital runway. In many sectors like software applications development, product development, chip design, telecom product development, that means introducing offshoring early on in the startup’s life and not waiting till later when certain milestones are reached.

The PE sector, in contrast, initially lagged behind due to a lack of exposure and expertise, and this has been corrected in the last 12-24 months as PE activity in the offshoring space – both in terms of investing in offshoring players and in acquiring companies that have strong offshoring potential in their operations – has dramatically risen.

VC – EARLY ADOPTION AND CONTINUED GROWTH

A confluence of factors is driving this accelerated focus on offshoring within the lifecycle of VC investments and startup operations. We have classified these drivers as early triggers – that initially sparked an interest in offshoring – and growth drivers – that have helped sustain the continued growth of offshoring in recent times. They are as follows:

Early Triggers

1) VCs need portfolio companies to reach breakeven much faster.

There is less emphasis on top line growth. Unlike the bubble years, VCs want their portfolio companies to breakeven at a lower burn rate ratio¹ and generate a positive cash flow much earlier in their life cycle. This makes the portfolio attractive to later stage investments since investors are looking for companies to be cash flow positive by the time they inject later rounds of funding.

2) Better capital utilization through offshoring allows portfolio companies to semi-hibernate during a downturn.

This is also true when startups have to make course corrections. For instance in 2001, when the consulting market in the US hit choppy waters consulting rates fell sharply. Bristle Cone, a supply chain management and implementation consulting startup, which charged an hourly of \$200/hr for its SAP consultants, had to lower its rate by more than 50%². They pared down their consulting arm and moved their development center to Bombay, India and survived the market downturn. Later as the market picked up, they brought their consultants back to the US. In 2004, the company was bought out and is now a thriving operation with three offshore centers in India. Bristle Cone would not have been able to withstand this exogenous shock without an offshore backup.

Growth drivers

1) Drop in exit valuations is changing return dynamics.

The average exit valuations for VCs have fallen steeply over the last 4 years. This drop in valuations at exit has tightened the early stage purse strings for a startup. This in turn has made offshoring an attractive option. For example we spoke to a VC with a chip design portfolio firm. Before offshoring became a major trend, a chip design company needed around \$ 40 million to reach the product development stage. By offshoring this number was reduced to \$ 20- 25 million³. Another example is a start up called Tejas Networks, an optical networking product company which has been incubated in Bangalore by US investors including Battery ventures and Intel Capital. The company has a development center in Bangalore with sales office in US and Singapore. Low cost development (in India) and quick market penetration (in the US) has attracted the interest of other VC firms to this model. In top tier VC funds like Kleniers Perkin and Norwest Ventures, more than 75% of the companies in their portfolio have already adopted offshoring as part of their operations⁴. As Jim Breyer from venture firm Accel partners puts it, “Rarely does a board meeting go by when we do not have some focus on being more aggressive about either offshore development in China or India”

2) Capitalizing on offshoring by creating new operating models.

We came across a startup, July System that has grown ground up via offshoring operations in India, funded by US VCs including Charles River Ventures, WestBridge Capital Partners, NeoCarta Ventures, Acer Technology Ventures, Jumpstartup and Silicon Valley Bancshares. Thus these specialized offshore focused funds are spawning startups that in some sense have a “reverse roots” – started operations in an offshore location later moved to the US.

From the VC point of view the benefits of this strategy go beyond simple ROI. Portfolio firms employing offshoring can offer services that hitherto were infeasible. One such service is product customization. Locating their development and production centers offshore gives startups the ability to hire many more people needed for product customization. This ability to customize products has meant that startups can boast of large clients like Dell and HP – these large customers typically require their vendors to provide a lot of customization. These flagship accounts boost the chance of survival and growth prospects for these startups companies, thereby presenting their investors with attractive exit options in the form of being acquired by large corporations. Accel Partners has funded companies in the product development space which have been successfully executed this strategy by employing offshoring.

EMERGENCE OF INVESTORS ALONG US-INDIA CORRIDOR

During our investigations we uncovered a number of specialized funds focused on offshore opportunities, such as WestBridge Partners and Acer Ventures, which invest money in the “US – India corridor”. Two types of offshoring-focused funds are to be seen. The first type are the relatively newly instituted funds like New Path Ventures and Artiman Ventures which focus solely on start ups with a major offshoring component in their operations. These funds have started off well and have been able to get good valuations for their companies. For instance, Nevis Network, a start up in the enterprise security space, funded by New Path Ventures (Series A) was able to raise series B funding from Nokia Venture Partners. Nevis Network is a US based company with an R&D center in the city of Pune – India. The second type of funds are those focusing on leveraged buy-out opportunities like California-based Crimson Ventures, which helps its buy-out portfolio companies to leverage outsourcing from Asia in order to reduce costs and thus enhance their profitability.

PRIVATE EQUITY – ONE STEP BEHIND, BUT CATCHING UP RAPIDLY

While there is sometimes a blurring of boundaries between PE's and VCs (especially in the popular press), our research suggests that the two communities have had very different offshoring adoption paths, with VC's embracing offshoring very early while PE's catching up rapidly in the last 12-24 months.

There are a number of reasons for the delayed PE response:

1) Conservative business models

Historically, PE firms are involved in the operations of the companies they invest in a less hands on way as compared to VC firms as borne out by a recent McKinsey⁵ study. This lends PE firms to invest in funds that in turn invest in individual firms. This "arms length" model of investing translates into a lower level of motivation for PE firms to leverage offshoring for their portfolio companies. PE firms, however, have started moving in the direction of utilizing offshoring services to improve their internal processes (see case study 1). Experience with offshoring in such limited fashion by PE firms might lead to a greater push for adopting similar services for their portfolio companies.

2) Limited technology focus

One of the major reasons for the initial lack of the PE exposure to offshoring was that PE's do not focus on technology companies as much as their VC counterparts. The traditional LBO deals have been done in the "old economy" sectors where the role of technology (the first corporate bastion to embrace offshoring) has so far been less significant. Now with offshoring of functions such as finance & accounting and payroll processing, PE firms are being forced to leverage offshoring to cut the cost in their portfolio companies. The recent announcement of a \$ 11B merger between Kmart and Sears Roebuck and Co,

owned by Edward Lampert's ESL Investments has prompted the combined entity to offshore its F&A work to achieve cost synergies.

3) Less experience with international investments

PE's did not have as much experience in making international investing decisions compared to VCs⁶ barring some firms like Warburg Pincus, General Atlantic Partners and Oak Hills Partners. Other PE's have had to cover significant ground before reaching the level of sophistication and comfort with the international component of offshoring in comparison to VC's.

4) More limited diaspora presence in PE firms

PE firms do not have a lot of immigrant representation at upper management positions. In VC firms on the other hand, the higher diaspora participation has allowed them to bring their understanding of and comfort with offshore locations to bear in their push towards offshoring.

A number of PE's have in the last 12-24 months become very focused on an offshoring strategy, and they are fast catching up with the VC community to become key shapers of the next wave of offshoring models. A number of factors are contributing to this acceleration of PE activity in the offshoring arena:

1) Cross border PE funds are emerging

An example is Crimson Ventures, a PE focused on helping portfolio companies leverage Asia for the outsourcing needs. These funds are gaining importance as business process offshoring is becoming more mainstream in corporate circles in sectors like retail, financial services, manufacturing services like engineering design, etc. These funds have so far given above average returns for their PE investor, which is opening the eyes of PE investors to the offshore opportunity.

These funds also are helping connect their portfolio companies with the specialized service providers in areas like payroll processing, finance and accounting etc. Crimson Ventures follows this strategy very well as it helps its portfolio companies in the manufacturing space to outsource its services to the outsourcing service providers in which it has some investments. This strategy has been a big success for the fund as one of companies funded by it, eTelecare, has become Philippines' largest third party call center and back office company with revenues of over \$ 55 million in 2004. This will create more opportunities for the PE's to drive their portfolio companies aggressively to offshore their operations in the area of F&A, payroll processing and HR.

2) Success stories are surfacing of PE's utilizing offshoring to improve profit margins of portfolio companies.

Our research has revealed that early PE adopters of offshoring have been able to achieve superior ROCE performance among their portfolio companies. Case Study 2 outlines a PE success story in offshoring the operations of a portfolio company. Competing PE funds are willing to pay higher multiples for companies which have either a large technology component in their operations and /or a potential of cost cutting by offshoring of operations, as they expect to extract higher cost savings than before, thereby improving earning multiples and valuations. This is beginning to effect the valuations of the companies in the LBO space who will be able to leverage offshoring better giving better returns to their investors.

3) The LPs (Limited Partners) in PE firms are pushing for superior performance.

In the last few years returns on PE investments have not done as well as returns on VC investments. There is hence a push "from the top" to take steps to improve average investor return. Offshoring is an attractive option for doing this.

TIMELINE

Late 90's-2000: VC firms using offshoring as a means to improve efficiency and reduce burn rate in portfolio companies

2001-02: With encouragement from the “early adopter” VCs, startups are increasingly incorporating offshoring as part of their business plans – i.e., at the point of inception.

2002-04: PE and VC funds emerge that focus exclusively in investing in BPO and other offshore oriented companies. Early success stories spur further interest and growth in this segment.

2004 – now: Selective PE's now actively using offshoring as a means to improve efficiency in portfolio companies, and to invest in companies that can substantially benefit from offshoring.

CHALLENGES

Early injection of offshoring into the startup lifecycle by VC's and by PE's represents a new frontier. Like any new frontier this too represents its own set of challenges.

1) Bounds on cost savings

Cost savings was the biggest driver behind the rise of services outsourcing of low end work. While cost savings continues to be a major theme in offshoring decisions, VC's have found that they cannot pinch pennies when it came to recruiting talent in offshore locations. This has led to situations of high upfront costs when one combines recruiting costs with offshore setup costs, making some companies question the wisdom of their offshoring decision. This is especially the case when this initial cost is being evaluated against a possible expansion of an existing onshore facility.

2) Intellectual Property Rights (IPR) concerns not resolved

The biggest asset in the case of many startups is the proprietary technology/process that they have developed. IPR is therefore a major concern among these companies, and this is a critical issue for the VCs who fund companies having a patentable product / idea in the market place. IPR issues are a real problem and even large companies have not remained unaffected as evidenced by an alleged IPR violation involving a Cisco promoted company and Huawei in China (recently resolved⁷). This has led to a situation where funds are hesitant to send cutting edge work to offshore locations thereby not exploiting the maturing offshore opportunity to its fullest potential. Interestingly, in an earlier paper⁸ by two of the authors of this report, we had noted that early adopter companies in the offshoring space like Nortel in the late 1990's were extremely concerned about IPR violation (in the case of Nortel their concern was around IPR violation in China). Almost 15 years later this concern has not been

satisfactorily addressed, and in fact it has only become more widespread as companies are offshoring work to many more countries.

3) Manpower challenges and the potential fallouts of attrition

As more and more companies start to look off shore for critical operations, the shortage of skilled manpower is emerging to be one of the biggest constraints to the pace of growth in this sector. A related issue is the problem arising from losing key personnel and the critical knowledge that leaves the door with them. This is especially a challenge for companies which have to invest a lot of money in training offshore labor to make them productive partners to the onshore team. IPR concerns are also accentuated with high rates of attrition and in the extreme case mass attrition can even risk business continuity.

4) Issues of cultural sensitivity are front and center

Issues of cultural sensitivity are front and center to the success of offshoring decisions and have to be addressed from the very beginning. During our research we came across an example of the company named Ishoni Networks, which was acquired by Philips in 2002. Philips was not on top of managing the cultural issues in this acquisition and could not keep the management team in India. This led to a situation where some former employees of Ishoni Networks formed a new rival company and tried to bankrupt Ishoni Networks, steal the employees and also steal the intellectual property. Since there was no person from the senior management team on the ground, things came to this crisis point.⁹

BEST PRACTICES

Offshoring represents a new way of doing business, and this is causing companies to rethink their organization structures and operations so as to best deploy and integrate their onshore and offshore presence. Companies are learning to rethink the classic

organizational tradeoffs (often by trial and error) between control and risk. Among the notable best practices our research identified are:

1) Offshore management presence now seen as a necessity.

Locating part of the management team in off shore locations was at one point a recommended strategy for startups – and it is increasingly considered necessary business practice.

The need to locate members of the firm at offshore locations goes beyond just the founding team. A related success factor highlighted to us by several VCs is that key staff members should have global operational experience and a willingness to work across borders. This brings with it the obvious challenges of managing and coordinating the activities of a global management team since an understanding of the onshore market (that the company is selling into) and the offshore market (especially the labor market, legal norms, property laws etc.) is crucial. Having someone who has worked in the US be present in the offshore location is in most cases the ideal arrangement, which goes back to the importance of the diaspora – since they are most likely to relocate. In fact the location of senior management was the most often cited success factor - by VC firms investing in startups or PE firms trying to improve the ROCE of the LBO companies - to the success of an offshoring arrangement.

2) Offshore team positioned as a close partner and as a critical factor to the success of the onshore team.

Startups that are new to offshoring are sometimes run parallel development and design programs in their onshore locations. The rationale for this is to build in redundancy, in case the offshore team fails to deliver. The VC's firms that we spoke to discourage this redundancy for a couple of reasons. One, given the need to conserve capital early on in a startup's life this parallel activity means an

unnecessary drain on capital. Second, this second guessing sends a very wrong message to the offshore team. The idea model should have a two way exchange between onshore and offshore teams. The design and specs flowing from onshore to offshore team, which implement the design and feed it back to the onshore team. The onshore team uses its proximity to the market to fine tune the product/service offering. This way each team reinforces the work done by the other without stepping on and making them is little justification to build in this kind of redundancy since onshore resources can be used to improve and design later versions of the product¹⁰.

3) Empowerment of middle management

Developing an effective middle management layer leads to decision making being pushed down the line, and this is extremely critical for the success of an offshoring operation. Especially for a startup with time to market constraints and a constant need to make course corrections, the centralized onshore decision-making process can prove counterproductive. An analogy can be drawn with manufacturing. US auto companies historically required management to take decisions on whether or when to stop production due to quality issues. Japanese auto companies empowered their shop floor supervisors in this regard and showed how this can have a positive impact on productivity and product quality.

CASE STUDY 1: PE FIRM OFFSHORES INVESTMENT RESEARCH

Background

A PE firm specializing in financial services and e-commerce investment deals was looking into the prospect of investing in an internet bank in 2002 in an environment of attractive valuations and early indications of an uptick in the market.

In order to come up with a valuation for the target bank the PE firm wanted to conduct a thorough due diligence on the target bank's business model, its key financial metrics, competitor analysis and the like. In order to do this, the PE firm employs a high end research firm specializing in the area M&A's, buyouts, investments and strategy formulation. The research firm has most of its analysts in India who conduct the primary and secondary research, while maintaining a small sales office in the US

About the investment target

Net Bank (NASDAQ- NTBK) the prospective investment candidate, was launched in 1996 and had been a stand-alone internet bank providing a full range of retail banking services including interest bearing checking accounts, money market accounts, IRAs, CDs, credit cards, insurance, mortgages and equipment leasing. Customers accessed the bank through personal computers, ATM, PDA, phone or mail. It served customers in the US and 20 other countries. In US the bank was very strong in California, Florida and Georgia.

Net Bank faced competition from regional banks, internet banks and big financial services providers like Citigroup, Wells Fargo, JP Morgan Chase.

Offshoring motivation and objectives

The rationale for outsourcing this due diligence by the PE firm to a research firm with a strong Indian foot print was:

- Lack of internal resources by the PE firm to do this level of due diligence
- A talented pool of research analysts at the Indian research firm and its track record of delivering a high quality end product, at lower costs than a pure play US research firm.
- Since this was an emerging sector, there were few analyst reports. Besides this since Net bank had small market cap (\$503 M as of 3/28/03) compared to big

banks a detailed study was difficult to get from any of the equity research firms in US.

Offshoring activity

In order to conduct a thorough due diligence of Net Bank, the research company used its team of financial analysts in India to come up with a decision matrix. This decision matrix was created through a combination of internal and external factor research.

As part of the internal factor research, factors such as Netbank's financial performance and operational performance were measured. This involved mapping out the profit margins, asset turnover, return on average asset and average total assets from a period of 1998 to 2001. This helped in the external research, which looked into the competitor profile, its financial position compared to its peers, market expectations from the deal and an event log of similar deals in the marketplace and reasons for its success or failure.

Internal Research

The internal research comprised of looking into the different product/ service lines, their contribution to the top line and bottom line, various strategic partnerships and cross selling opportunities. Each product/ service line was then further broken into banking products/ services, lending programs and major non-banking financial services like brokerage, insurance, currency exchange and electronic bill payment. A major component of the internal research was to map out the Netbank's operational performance and look into the key financial parameters like Sales, Total Assets, Asset turnover, Return on Assets and profit margins over a period of 4 to 5 years to get a better sense of the financial health of the bank.

External Research

The operational and financial analysis data was used to do a financial performance analysis of NetBank compared to its peers. This comparison of the financial parameters like P/E ratios¹¹ for trailing twelve months, return on average asset and number of online

bank accounts was done both for the competitor internet banks as well as for the traditional banks. A monthly total return to shareholders chart was also plotted in comparison to the other players. This was an important to the private equity firm as it was planning to be a shareholder in NetBank.

Results

The research firm concluded that the deal was worth pursuing for the private equity firm as NetBank was profit making bank at that point of time and was expanding through M&A and strategic partnerships, thus expanding the customer base. NetBank being an online bank, the fixed cost were low, the average customer had higher per capita income and, being one of few successful internet banks, it was a viable investment candidate.

In 2005, NetBank still operates as a profit making Internet bank. The bank has achieved sales growth of 15.29% in last 3 years¹², has paid dividend over that time and has strengthened its operations in fast growing mortgage loans market.

The impressive performance of NetBank has augured well for the PE firm, which, based on the due diligence, invested in the bank. The PE firm was happy with the investment and credits the thorough and systematic due diligence done by the offshore firm as a key element in its decision process.

Learnings

The major emphasis of offshoring in the PE/VC context has been in two areas, namely:

- 1) Improving the financial performance of portfolio companies, and
- 2) Investing in new business opportunities that are arising from offshoring,

This case study shows that there is a third benefit that PE/VC firms can also go for, which is:

- 3) Lowering the costs of, and potentially increasing the output from, internal VC/PE activities such as research and due diligence.

CASE STUDY 2: PE FIRM IMPROVES OPERATIONAL EFFICIENCY AT PORTFLIO CO.

Background

A leading US based buyout fund focused on improving the efficiencies of acquired companies bought a US based firm that provided an information platform for corporate jet owners, managing fleet maintenance information and providing web based technical support.

Offshoring motivation and objectives

In a bid to cut operational and fixed costs it was decided to move the acquired company's technical support operations to India. The funds saved from this transition would allow the firm to develop tools that for better data collection and analysis in order to go after new business by proactively calling clients.

Offshoring experience

As the firm transitioned part of the technical support to India, they noticed some degree of anxiety as senior management had to make many trips to India to help setup the center. Not all senior management had been involved in leading cross border operations, which turned out to be a challenge.

Results

Offshoring helped boost the financial performance of the company significantly. Between the years of 2000 (pre-offshoring) and 2004 (post-offshoring), the annual sales of the company remained flat at \$20 million. However, the annual free cash flow in the business increased in the same time frame from \$5 million to \$10 million. The PE firms expect that this will positively impact the exit valuation of its portfolio company.

A secondary benefit from offshoring was that the company was forced to standardize many of its disparate sub-processes. This has helped improve the company's cash flow situation. In addition, the offshoring experience gained by the PE firm allows it to apply it to other companies in its portfolio.

Learnings

The big takeaway from this case study is that offshoring can have significant impact on mature, non-tech oriented PE portfolio companies.

SECTION B: RETAIL

INTRODUCTION

Offshoring activities by retail financial services companies have captured a lot of media and public attention. With heated debated still raging on the employment and customer service quality implications of offshoring, retail financial service players have, not surprisingly, taken a very low profile approach to exploring and adopting offshoring. As a result, there is only limited cross-organizational understanding of benchmarks and best practices, slowing the pace with which the industry can learn and improve its offshoring programs. Additionally, our research reveals that this sector has witnessed a mixed bag of results so far with offshoring. On the one hand, offshoring has shown clear cost benefits and an increasing ability to handle more high-end, sophisticated operations. On the other hand, performance is not always at par with onshore operations, especially in call center work. Despite their unwillingness to discuss offshoring in the public eye, we find that retail players are almost universally bullish about the impact of offshoring and their intent to grow its adoption in the near term.

DRIVERS

We identified two early drivers behind adoption of offshoring in the retail financial services:

Early Triggers

1) Opportunity for scaling flexibly with low investments

The retail financial services business is increasingly being commoditized, and this is pushing margins down in the industry. Players are seeking to bolster margins by engaging in process innovation such as providing better and longer hours of service to clients, cutting down the processing costs & time, and data mining

existing customers to provide with them with more customized products based on their buying patterns and demographics.

This requires significant infrastructure investment, which can become a drag for publicly listed companies. During our research we came across a major retail financial services player in the US who estimated it needed an investment of around \$100 million for call center expansion to support its growing customer service needs. Since the company operated in part at the low end, low margin end of the retail market, it had relative low average customer margins and revenue streams. Offshoring helped the company scale their customer service operations in line with their business expansion in the US and provide faster turnaround times as more personnel were deployed to provide inbound and outbound call center support – all this while reducing the upfront investment. In essence, third party call centers in offshore locations worked as “force multipliers”¹³ – facilitating a substantial enhancement of their service offering without a corresponding need for investment. The concept of force multiplier can also be used during down time in business as the companies in US can convert the fix costs into variable costs and can increase their business or lower the calling time (in this case) without a need to create new facilities which will require capex investments.

2) Opportunity to evenly spread out cyclical operations

The retail financial services industry has highly cyclical elements and the companies in this sector are often caught between having too much or too little capacity. This is particularly true in the mortgage processing industry where the interest rates affect the market and there are sharp peaks and troughs in the market. The offshoring in the mortgage industry started in 2001 and now part of call center and other back office work in the mortgage sector is being done in offshore locations, mainly India. Call center work being offshored includes lead generation while other work being offshored includes filling of form 1003, data

entry and loan closure. In this area the offshoring is being done both at the retail (mortgage brokers serving their clients) and at the institutional level (mortgage banks serving mortgage brokers). This market segment has become so attractive that niche offshore players with exclusive focus in this market have emerged, such as Indecomm, PE funds like WestBridge and Acer have started funding service providers in this space. This trend will intensify as interest rates rise in US thus slowing down the refinancing market and forcing the mortgage banks to improve their services and lower their processing costs.

We found examples of banks offshoring cyclical processes, where the volume of business is driven by the existing interest rate regime. (Banks like IndyMac and Green Point) We have seen a similar phenomenon on the institutional side of the business also.

TIMELINE

Business process offshoring in the retail financial services sector started in real earnest around 1999 when third party vendors started providing these services to US companies. Our timeline charts out the evolution of retail financial services offshoring in four stages. A prime example of a stage 1 company is E-Daksh, which started by providing email support to US companies. E-Daksh went on to attract funding from private equity players like General Atlantic Partners (GAP) and Oak Hill Ventures and was in 2004 bought out by IBM Global Services in a deal worth \$ 170 million.

TIMELINE

Stage 1 (1999)

Customer support – Email support, early bucket collections¹⁴, inbound telesales
Outbound telemarketing

Stage 2 (2001)

Collections (Ex: Global Vantage)

Data entry

Stage 3 (2002)

Fraud Detection

Recovery

Stage 4 (2003 onward)

Dispute resolution

Data Analysis

Another stage 1 company with a focus on outbound and inbound telemarketing support is Spectramind, funded initially by Chrys Capital and eventually bought out by Wipro. The companies formed at this early stage of evolution in the BPO space went on to become large volume players across various horizontals. A further example is EXL services, which started as a subsidiary of Consec and eventually was part of a management buy out led by Oak Hill partners. This firm has also become a large volume player across different horizontals.

In stage 2, some niche players came into the picture as the offshoring focus started shifting to work that was more specialized. This included collections, F&A (finance and accounting), lead generation (e.g., for mortgages) and data entry.

Stage 3 saw the further advancement up the value chain of financial services offshoring. Companies such as Epiphany offered F&A along with forensic services in the field of accounting. US companies such as Accenture also set up their centers in India at this time.

In stage 4, offshoring has moved into even more sophisticated areas such as data analytics and data mining. These kinds of services can be used by retail financial service institutions to customize their products, detect and respond to new trends in the marketplace and to support the analysis of new product offerings. Companies like B2K are prime examples of this trend.

THE REPORT CARD

Has offshoring lived up to its promise in the retail financial services space to speed up process innovation while keeping costs low? Our findings indicate that offshoring to date has delivered a mixed bag of results:

1) Quality of call center work in offshore locations – jury still out there

Call center transactions quality via offshoring is generally not up to US standards. Our research in the retail financial services space showed that inbound calls are the hardest to match in terms of US quality levels. In one case the quality level (measured in terms of customer satisfaction scores) was down around 12- 14% from the average US levels. Quality particularly tends to deteriorate when organizations rapidly evolve a call center operation from pilot to full scale. Another challenge in maintaining quality levels is the high attrition rates in the offshore service centers that are handling these processes. Whenever there is a turnover of experienced team leaders, it inevitably leads to a perceptible drop in service quality and turnaround time.

Lower cost via offshoring is one factor that is balancing the quality losses. One US company we spoke to told us that even though the quality of their inbound calls offered from India does not match that from US call centers, the overall economics are so compelling that it still makes sense to send work offshore. Thus, instead of establishing parity with US operations, keeping the cost down in inbound tele-support work while maintaining a minimum level of quality may be

a viable strategy for service providers. Some providers like V-Customer, a Warburg Pincus funded call-center company, are focusing on becoming a low cost volume player and has a very small onshore team. They have been able to keep the cost at \$ 15,000 per year per agent which is around 1/3rd of the loaded cost in US. This business model has helped the company grow quickly – V-Customer was the 3rd fastest growing services company in US in 2004.¹⁵

2) Back office work quality is at par (or better) than US standards

In the case of back office operations, especially in mortgage processing, credit card billing process and collections, offshore locations like India have been successful in attaining the quality levels comparable to US. This has led mortgage banks and administrators to send end-to-end work to offshore locations. The specialized service providers have been able to develop technology platforms which have helped to cut processing time for the mortgage banks and administrators. As one example, Indecomm developed a work flow tool for the mortgage industry which helps to automate the loan processing and other related work performed traditionally by mortgage administrators.

While the cost vs. quality debate continues, one thing is certain. The prospect of sending work offshoring is a trigger for standardization and codification of processes. This leads to ease of benchmarking and better performance tracking of processes in the long run

Companies need to codify and define their processes before they are offshored. This helps them to define the service level agreements (SLA's) and also to monitor the performance of the service providers better. This has fueled a demand for consultants who have experience in streamlining processes and developing frameworks for the transition of the processing to the offshoring locations and the governance structure to be developed for the transition and the ongoing monitoring of the offshored processes.

OUTLOOK, BEST PRACTICES, AND EVOLVING BUSINESS MODELS

Where are we headed as retail financial services players get more accustomed to the idea of offshoring? Our investigations suggest an interesting dichotomy: All call center offshore services are NOT low end; all non-voice offshore services are NOT high end.

Our research showed that all call center work is not low end as commonly perceived. Mortgage lead generation for high value loans, commercial financing, and collections of large receivables are all examples of high value offshore work in terms of the billing per hour. This kind of work requires specific skills and there are entry barriers in terms of licensing, agent training and bond requirement (service providers need to take the risk of underwriting the transactions). Consequently, the billing rates are high. Besides, these processes also involve back office work in order to close on the transactions, and thus they are a complex blend of low volume and high value work. In contrast, data entry work in mortgage processing as well as credit card processing commands a much lower hourly rate.

An interesting offshore business model is appearing as a result. Specialized players in the retail financial services space like the mortgage market are moving away from the per hour rate¹⁶ to a transaction based pricing model¹⁷. The latter is a high risk, high revenue model compared to the former. The niche players who have developed competencies in various stages of mortgage operations now aim for the transaction based model. This model incentivizes these niche players to exceed deliverables beyond those specified in the Service Level Agreement (SLA) because now their revenue increases commensurate with their ability to exceed these levels. The advent of this model indicates a shift away from pure cost arbitrage in the mortgage market as quality and productivity will have an increasingly central role. Initially it is easy to cut cost but if a service provider wants to constantly increase the revenue per client the quality of the process and the productivity of its employees has to go up. This model has not yet seen mass adoption, especially not by the larger service providers, since these providers are more comfortable in dealing in volumes and are less specialized in any one vertical compared to the niche players.

Special note of security considerations when offshoring and steps being taken to mitigate the problem

In view of the recent incident of identity theft at a service provider based in India, where three employees stole US\$350,000 from Citibank account holders, the data security issue in offshore locations has become a central concern. During our research and conversation with the industry players¹⁸ we came across certain measures being taken by service providers for customers in the retail financial services clients having a large incoming call volume. These include:

1. Dynamic Data masking - Ensuring that agents don't get full exposure to key confidential data
2. Paperless Office - Using automated workflows and electronic note pads, service providers are enabling a completely paperless office, ensuring that no data can be taken out of the production floors.
3. Automated Monitoring and Alerting – A Business Performance Management platform is enabled to track systems usage in real-time and create alerts in case of deviations. Besides this an automated call monitoring software is deployed, which publishes alerts and prompts supervisor to listen in on the call when words like "password" are recognized.
4. User Provisioning - This system manages access to all systems based on user entitlements. It supports the process of employee on boarding, transfers and exit, as well as real-time monitoring of systems access by employees.

NASSCOM¹⁹ has also outlined a plan for stricter privacy protection laws by end of 2005. It will include greater self regulation by the service providers, greater awareness of the security concerns and higher standards of encrypting sensitive information.

The issue of security of the data at offshore locations will become more important down the line as the nature and sensitivity of data being processed in offshore location increases²⁰ in line with tighter regulations– Health Insurance Portability and Accountability act and Sarbanes Oxley being two prime examples.

In order to avoid any surprises, companies which are planning to offshore their operations need to have well defined risk tolerance strategy which should be based on the sensitivity of the operations being offshored to the operations of the company. One strategy being employed by some companies is to retain control over security. The approach here is to formulate rules, lay out the infrastructure and monitor the vendors including periodic security audits.²¹ This entails an extra cost – for highly sensitive data, the clients may need to forgo savings of around 15 to 19%²².

CASE STUDY 1: FINCORP (DISGUISED US RETAIL FINANCIAL SERVICES COMPANY)

Background

This first case study profiles the timeline of a typical offshoring operation and identifies best practices and implementation lessons. It follows the offshoring experience of a large US based retail financial services company, FinCorp

FinCorp has call centers in the US and it was expecting substantial growth in its core business. In order to position itself for a surge in call volume while keeping the capital expenditures down, the firm decided to leverage the maturing call center offshoring wave. This is their story.

Timeline and evolution

October 2000- Hired a VP level executive from GE to open two contact centers that would take care of the surge in business. If the call centers had been set up in the US, the investment would have been in the range of \$100 million

Jan. 2001- VP goes over to India and visits 14 different vendors. In an environment of a cluttered vendor base with no clear winner, FinCorp considers building its own contact center.

Feb 2001- VP meets with an Indian vendor (Vendor 1) with a specialization in financial services with a management team who has had past experience in this area and has been doing some work for a major US banking institution.

June- 2001- FinCorp launches pilot with Vendor 1.

End August 2001- After first month of the operation, kind of work being done and level of efficiency being achieved is considered to be very good. COO of FinCorp decides to ramp up work with Vendor 1.

Sept 2001- Two months of pilot completed – FinCorp's SLA's are being met. At this point, FinCorp decides not to build its own contact centers but to outsource the work to 3rd party vendors. FinCorp decides to ramp up its offshore call center operations from 50 to 250 people as customer satisfaction level is comparable to US.

Feb. 2002- FinCorp's US team starts coordinating with its UK division so that it may also offshore work to the same vendor (Vendor 1) and not engage in a separate exercise to select new vendors.

March 2002- As the operation is ramped up, FinCorp notices deterioration in the performance delivered by the offshore center.

June 2002- Most of the team members that started off on project in Fall 2001 have left Vendor 1 (due to attrition) and Vendor 1 is left with the onerous task of hiring and coaching about 340 people over a short period of time

July 2002- Customer satisfaction scores are down compared to US levels (12 to 15%) and call handle times have gone up. Company decides to prototype a second contact center with another vendor (Vendor 2) mostly doing telemarketing. Initial prototype results are encouraging and Company decided to ramp up operations with Vendor 2.

3rd Quarter of 2002- Vendor 1 is unable to fulfill all SLA commitments. Meanwhile, cost pressures continue to force FinCorp to offshore more work to India.

1st Quarter of 2003- Vendor 1 brings on a full time senior manager in charge of relationship with FinCorp. Quarterly business review leads to an extensive discussion of quality and handling time issues with vendor. Effective communication helps Vendor 1 improve performance, as handle time improves and all metrics are on target.

July 2003- Vendor 1 is doing well. Vendor 2 has stabilized. Company opens call center in Latin America.

Overall there is still a gap of 5 to 7% between domestic and offshore contact center performance levels. Company decides to live with this performance gap since the cost savings are substantial. Company decides to further ramp up operations with Vendor 1.

In 2004 performance trails off and it is down an avg. of 12% compared to domestic performance.

Results

With call center performance being satisfactory though lower than US levels (by an average of 12% based on customer satisfaction scores), FinCorp is continuing to actively utilize offshoring in its operations. The following areas are currently being offshored:

- Customer support – Early bucket collect, inbound service calls
- Collections
- Telemarketing
- Data entry
- Fraud Detection
- Recovery
- Dispute resolution

Learnings

1) Attrition challenges

With a big influx of foreign firms into the Indian market eager to tap into the labor pool, attrition rates among employees are high. FinCorp admitted to a very aggressive offshoring schedule in the face of cost pressures, which led to performance issues. Contact center jobs are increasingly perceived in India as “bottom of the totem pole” jobs. Indian employees do not want to do this job on a long term basis and on average stay for only 9 months and then shift to non phone jobs.

2) Call center performance

In addition, there are some management issues to be addressed in call center work. US based agents clearly have a better knowledge of the US customer psychology, necessitating strong training and supervision in the India call centers.

In FinCorp's assessment, middle management in India is not very strong and the management bench is quite weak.

3) Challenges of ramping up

There can be a large gap between performance levels during a pilot and when operations are ramped up. Companies have to be ready for a drop in quality and should have ongoing channels of communication with their vendors. Both parties should expect some sparks to fly during these quarterly meetings, a sometimes unpleasant but essential step towards course correction.

4) Management resource requirements

Senior management needs to provide strong support and management resources to build out and manage the offshoring programs, even with the use of 3rd party service providers to actually execute the offshore operations. FinCorp had aggressive plans to offshore but did not have the decision makers on the ground to support that plan. There was significant change in responsibilities in the US team. A lack of long term planning on the part of FinCorp led to communication gaps with the vendors and caused many temporary setbacks.

CASE STUDY 2: DECISIONING RISK AT AUTOLOAN, INC. (DISGUISED RETAIL FINANCIAL SERVICES COMPANY)

Background

Autoloan finances over \$5 billion of loans annually, processing over 3 million applications. Its existing risk model used a *single* severity factor across the population

\$ charge off / unit % charge off rate

However, actual behavior indicated a variation of over 80% in the severity factor across all 10 segments of decisioning. Autoloan therefore wanted to assess the potential of building a model in the approval process to predict the collateral value of an application and identify a *segment level* severity factor for more accurate \$ loss rate prediction.

Offshoring approach

An offshore service provider was signed up to undertake this analytics project. This company put in place a joint on-shore/offshore team. The US side interfaced with the business owners while the India side focused on the analytical core of the problem. The heavy analytical requirements of the project were addressed by the service provider's India office with its access to highly qualified, trained and motivated business analytics specialists.

The offshore team engaged in significant interaction with the business owners as their buy-in and ownership of executing on the solution was key for real impact. To make the team structure with remote interfacing work, methodologies such as task allocation, interface points, accuracy checks, time zone coordination and client interfacing were developed.

Results

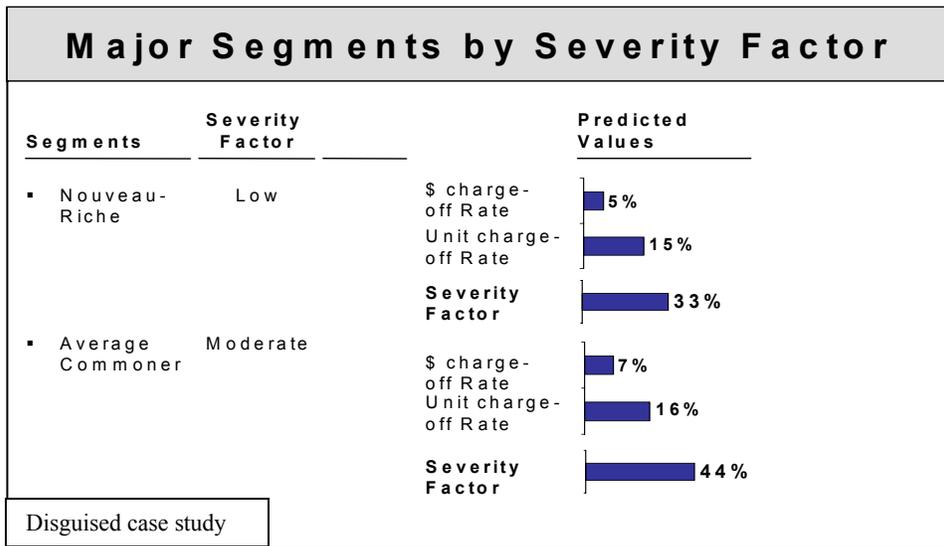
The project generated an impact of \$2-3 million from (a) using different severity factors for different segments of the population via better decisioning and lower credit risk and (b) improved market place product pricing.

Sample results are shown below. Two major segments were observed (classified as Nouveau Riche and Average Commoner) with significant difference between their severity rates and hence potential for a differentiated product/price offerings. The Nouveau Riche segment had a severity factor of 33% (making it less risky) while the Average Commoner segment had the severity factor of 44% (making it more risky).

The net value generated for the financial services company was \$500,000-\$700,000/man month – a range that is many times the cost of the offshoring investment.

Learnings

Offshoring is moving upstream -- financial services companies are starting to embrace offshoring in highly sophisticated knowledge-intensive areas. Success in these higher-end areas requires careful planning and execution of task definitions, interfaces, milestones, and accuracy checks.



CASE STUDY 3: OFFSHORE ANALYTICS FOR FININFO, INC. (DISGUISED US FINANCIAL INFORMATION SERVICES COMPANY)

Background

FinInfo is a Fortune 500 company that is a leader in providing global business information, tools, and insight. FinInfo had recently invested in a new database to drive business insights, but this was not being fully leveraged given the lack of a cross functional and flexible team who could utilize the system.

FinInfo was seeking ways of managing their analytics resource requirements in a cost effective manner. After one full year of effort, it was still proving hard for the firm to find resources with the right analytics skill-set, making the internal hiring goals harder to achieve

Offshoring objectives

FinInfo undertook an offshore engagement with an analytics service provider. It had the following objectives:

- Identifying a high caliber team with a overall view of FinInfo's new database to draw business insights
- Augmenting existing analytical capability in a cost effective manner through a dedicated team of analytic resources that was immediately available
- Acquiring the flexibility of ramping up / down the resources beyond the dedicated team on a short notice to meet their urgent / future analytics requirements

Offshoring approach

The service provider assigned cross-functional analytic resources from their India office. This offshore team was a blend of programmer analysts, modelers and an onshore project manager dedicated to them on a long-term basis.

The first month was spent in transitioning the work from FinInfo staff to the India team. The initial efforts were focused on defining the roles and responsibilities of each team member and developing processes/protocols for project management and communication.

The onshore project manager worked closely with the FinInfo program manager to ensure the following in delivery of projects under the arrangement:

- Sufficient project pipeline was built up for the team
- Data source person of the FinInfo was identified and tapped into for resolving data-related issues
- Work was allocated to the team members based on their skill sets
- Issues were resolved through daily, weekly and monthly updates
- Project deliverables, quality and deadlines were strictly adhered to by the team
- Productivity, resource utilization and variance from budget was tracked and communicated
- Knowledge management material was created and shared with FinInfo as and when needed
- Project feedback and performance rating was captured from project owners and shared with the Steering Committee on a regular basis

Results

The cross-functional structure enabled the team to provide insights into FinInfo's new database and to work across a breadth of business problems of varying degree of complexity. FinInfo gained 30% cost savings in their direct resource costs (salary and

bonus) while meeting their internal hiring goals. The team outperformed the expectations of FinInfo along the objectives, including smooth delivery of projects from the virtual offshore team and quick ramp up of additional resources on a short notice

Learnings

Like Case Study 2, this case also illustrates how retail financial services companies are starting to embrace very advanced applications of offshoring, and how these applications entail a careful and customized design and execution strategy.

SECTION C: INSTITUTIONAL

The institutional sector has lagged behind retail in its adoption of offshoring. This is largely understandable, for the nature of institutional back-office work makes it less easily outsourced. The work is complex, and the cost of a drop in quality is much higher. As a result, more rigorous training and monitoring are required. However, given offshoring's ability to deliver compelling cost advantages and a 24/7 service window, and the increasing number of offshoring success stories at the high end of the operational spectrum, we expect to find more and more institutional players taking advantage of a maturing offshore industry – likely with a greater direct involvement in the setting up and management of the offshore operation than has been witnessed in retail.

DRIVERS

Our research identified the following drivers behind adoption of offshoring on the institutional side of financial services.

Early triggers

1) Cost control

In the lean years from 2002-2003 after the bursting of the dot com bubble, the institutional side wanted to control costs and focus on core areas. This meant taking away repetitive tasks from analysts thereby increasing their ability to cover more sectors and more companies within a sector and to conduct deeper research about emerging trends and the nature of the deals in specific sectors. The firms we interviewed said that by taking some of these tasks off the plates of US analysts, the quality of their research has increased. In addition, some firms have enabled institutions to invest dollars to create online tools (in many cases developed by offshore service providers) to do real time tracking

2) Smoothen the personnel hiring curve

Given the cyclical nature of the institutional business (closely tied to the ups and downs of the stock market), one of the biggest challenges for I-banks is to smoothen out their personnel requirements in line with the ebb and flow of the I Banking business. One emerging business is in having service providers hire analysts and managers at offshore locations, thereby assuming the hiring risk (large number of personnel on the bench in case of a drop in client work).

3) 24X7 service window

This is relevant for the processes where a lot of paper work is involved. Case Study 1, which profiles a mortgage bank and their institutional clients (mortgage brokers), shows that the former is able to use the staff in India to fill out the forms and carry verification during day time in India. This has helped them to shorten their loan processing time. The 24x7 service window also a number of time-sensitive services to clients on a real time basis like preparation of presentations, doing fund accounting and tracking. For the commercial banks, it includes reconciliation and for the brokerages it means faster settlement of the trades and closure of their books.

Growth drivers

1) Offshore based initiatives creating firm-wide impact

Our research identified an interesting trend wherein initiatives undertaken at offshore locations are being rolled out across the organization. Case study 2 and 3 provide a vivid picture of this trend.

2) Need for backup/disaster recovery sites

An operations manager highlighted to us the need faced by investment banks to locate backup facilities outside US borders to ensure business continuity in the post 9/11 world. In the case of the investment bank where this operations manager worked, they chose Singapore as their offshore site since there were already some non-critical operational functions being performed at that location. By moving offshore, the bank was able to consolidate 5-8% of operations staff thereby taking advantage of the economies of scale of working with one offshore group. The one offshore group also gave the bank the ability to focus investment dollars to improving its process, to establish one system and to get clients to call one location to discuss payments/settlements/reconciliations. This bank was not too bullish on offshoring to developing countries like India and Philippines and in general avoided locating back office operations in greenfield locations. Since its processes were mostly low volume/high skill and it expected a 2+ year requirement for training staff in such locations, thus making them unattractive. (Other banks, however, are reporting early success with offshoring such activities to developing countries.).

TIMELINE

Stage 1 (2000)

Preparation of presentation collaterals: This was the earliest work to be offshored. Given the deadline driven nature of this work, US companies benefited from getting work done overnight in India and having it ready for the next business day. One of the early service providers in this space is Office Tiger, which set up a center as early as 1999 in Chennai, India. This kind of the work has been considered low-end work in the investment banking circles.

Stage 2 (2002)

Primary research (equity research): The falling stock market, the post bubble recession and creation of Chinese walls between the equity research and investment banking business in US led to a situation where the investment banks wanted to separate their research divisions. The existing off shore service providers for the investment banks moved up the value chain to offer this service to investment banks. Among the benefits that have accrued to the banks in this area are the increased quantity of analyst coverage (# of companies, sectors covered), the enhanced quality of coverage (junior offshore analysts freeing up the time of senior onshore analysts) and the broader scope of coverage (coverage of emerging markets).

Stage 3 (2003):

This stage included the following set of activities:

- Secondary research
- Financial analysis and modeling (similar to case study 3 in retail section)
- Global training and development programs for financial institutions (see case study 1 in this section)
- Development of tools to aid bank strategy formulation (see case study 2 in this section)

Offshoring of secondary research is an interesting example of a cost savings driven initiative evolving into more sophisticated work. Secondary research includes doing company or stock specific research for hedge funds/ private equity firms to help them in their investment decision process. Most of the research houses in US cover companies with a market cap of greater than \$200 million²³. Hedge funds and PE firms have an active interest in ferreting out opportunities wherever they exist²⁴. In many cases this means the lack of coverage of smaller firms hinders their investment decisions. Besides, secondary research is manpower intensive because it involves a long list of activities, often quite standardized. Secondary research at an offshore location gives firms the ability to employ many more analysts due to the lower salary cost in offshore locations. This research has helped hedge funds and PE firms unearth attractive investment

opportunities, which hitherto were not on their radar. The case study of due diligence work done by an Indian research company for a PE fund for making an investment decision in Net Bank shows the benefits for using offshoring resources for doing a competitive analysis for a target company. Hedge funds and private equity funds are at the forefront of this trend especially as hedge funds move into private equity space while the latter try to get better returns on their investments.

Another service provider provides an audit service to the mid tier investment banks for their financial models and also help them to upgrade their financial models based on the changing market scenarios. This kind of work could not have been done in US as these banks do not have the resources to audit their models on a regular basis. Since the models are critical for their trading revenue flows, the audit helps them to boost their top line and bottom line.²⁵ I-Banks are also starting to tap offshore service providers in the area of M&A by getting part of the due diligence and competitor benchmarking work performed offshore. .

Stage 4 (2004 onward)

Fund performance tracking and analysis

More recently, higher end institutional work is being sent offshore. This is driven largely by the availability of sophisticated skill sets at offshore locations. During our research we found that a service provider has started providing fund performance and tracking service for a fund of funds which has over 400 funds in its portfolio with exposure to about 4000 assets classes. The monthly and quarterly monitoring of the funds has helped this fund track on a real time basis the value and performance of its portfolio. This could not have been done earlier as the fund of funds found the cost of recruiting such high skilled manpower prohibitively high in US. Our research indicated that this will become an increasing trend as the returns in the developed market go down while the funds come under increasing pressure to provide better returns to their limited partners as well as cut their administrative costs. With alternative investments becoming an important component of the investment bank fund portfolio, we think the opportunity for offshoring of fund tracking and fund accounting will gain momentum down the line.

DIFFERENCES BETWEEN INSTITUTIONAL & RETAIL

The skill sets required for doing institutional back office work are considerably more sophisticated than the retail side of the business. Even for a seemingly mundane call center offshoring operation, institutional clients mandate long hours of training since they are exposing their clients (which are almost always more sophisticated and higher margin than retail clients) to offshore call centers.

Also, the institutional work done at offshore locations is often of a highly critical nature where quality needs to be tightly controlled - for instance a badly conducted due diligence might preclude an otherwise good investment opportunity. Worse, it could lead to a under par investment decision.

Another challenge is that some part of that institutional work is non-standardized, like making pitch books for different sets of clients or doing secondary research in different sectors as well as model auditing for the banks.

These differences have a number of implications on the way offshoring works on the institutional side. The average hourly rates for offshore workers working on behalf of institutional firms are therefore higher than their retail counterparts. Offshore service providers trying to grab the high margin institutional business face a steeper learning curve. In many cases employees in emerging markets have not worked with or dealt with sophisticated investment products/services sent offshore by institutional clients. This requires employees to undergo more rigorous training and also create a bench strength of skilled resources, since these skills are in high demand and are more likely to be poached by other service providers or captive centers.

OUTLOOK & EVOLVING BUSINESS MODEL

The choice of offshoring models adopted by institutional firms depends on the process being offshored and its criticality to the firm, IPR issues and the availability of third party

service providers in that domain. Our research shows that institutional players are adopting a hybrid offshoring model.²⁶ Another emerging model is the third party captive model where the specialized third party providers work in the offshore facilities created by the I-banks in India²⁷. In this case the staff is on the payroll of the service provider while the infrastructure is provided by I-banks. Besides this the I-banks as well as hedge fund administrators are opening their own captive centers in India. E.g. Globe Ops – a hedge fund administrator has an offshore center in Mumbai, India where it employs around 200 people and does fund accounting and portfolio accounting work for their hedge customers based in US

The institutional sector is a difficult space to enter for offshore service providers as it requires a management team that has experience in the institutional financial services business, credibility in this area, and deep pockets to train and retain high skilled employees who will be able to execute this kind of work. This also requires a big investment on part of the institutional player that wants to offshore some of their processes in terms of transition cost. For example, a hedge fund based in Connecticut partnered with a specialized service provider in India to offshore their fund and portfolio back office work to India. The one time cost of transition, training and set up amounted to around \$400,000 for a 20 man operation based out of Bombay²⁸

CASE STUDY 1: MORTGAGE PROCESSING

Background

A leading mortgage bank in the US started business process offshoring in the year 2000. *The bank gets 80% of the business from mortgage brokers.*

Offshoring approach

Lower cost was the major driver for the bank to start offshoring. The total cost of doing the process in the US was \$ 50-55K. In India the annual labor cost was around \$ 20- 25K

besides the costs of supervisory staff in US, training and transition costs and costs to safeguard against attrition in India (by creating some bench strength). The effective cost savings were around 20- 30% once the transition was complete. The bank adopted a co-source model with a specialized vendor in India. As part of this co-sourcing model the infrastructure and staff payroll costs would be borne by the service provider. The managerial staff (in India), who were process experts and would provide guidance to the junior staff, would be on the payroll of the bank.

Offshoring process

Loan products being handled from India include straight through loans²⁹ which are Fannie and Freddie Mae conforming products. These are usually low margin loan products for the bank and required quick turnaround time. Prior to adopting offshoring, the bank used an automated technology platform where the brokers would enter loan details and the branches would process the loans based on the geographical region where the property was located. This required the bank's branches to start processing the loans in the later part of the day for which they had to stop accepting loan applications by noon of that day. Thus any loan application received after noon had to wait 24 hrs before it could be processed (and sent back to the broker if certain information was missing).

In the offshore model the bank employs the offshoring center out of Bangalore for the low margin straight loans. It accepts loan applications from the brokers till the end of the US business day and then during the night hours in the US, teams in India work on checking the completeness and accuracy of loan applications by running it through a check list, thereby facilitating a decision on the application. The brokers in the US can check the status of the applications the next morning and in case of specific queries for the brokers, the bank's US staff can co-ordinate that information gathering effort in the morning. The result is that the processing time is reduced by 24hrs and the brokers can get better service. Lower turnaround times meant better service to the brokers and thereby better services to the end customers.

Another more sophisticated kind of work handled through the centers in India involves complex (more custom) loan applications, unlike straight through Fannie Mae and Freddie Mac products. In this case the loan applications are scanned and imaged in India. The images are checked for accuracy and completeness in India and indexed (during the night hours in the US). In case there are any problems the issue is escalated back to US. Besides this there are cases where some information has to be obtained from the records of the title companies. In those cases the team in India sends out the fax to the title company asking for the relevant information.

In addition there are a host of procedural tasks required to close a loan application (like verification of the employment for the loan applicant). This is also handled from the India center. These tasks had traditionally been performed at the branches and given the nature of the work received low priority, thus holding up the closure of the loans and affecting the productivity. Now the team in India performs the secondary and primary checks, which includes doing online searches, calling up the employer to check the details about the employee. Anywhere from 20-30 such tasks that are necessary for regulatory compliance, but are not customer centric, are done from dedicated teams in Bangalore, leading to quick and accurate decisions on loan applications.

Results

In addition to a quick turnaround, offshoring has helped free the staff in the banks branches to focus on customer care and sales initiatives. The costs savings are being reinvested providing better customer care by adding more call centers and providing longer hours of service. The bank has been able to reduce the call waiting time from an average 2- 3 minutes to less than 30 seconds by opening well staffed call centers. Offshoring the call center operations has also helped the bank to operate the call centers longer than before (earlier they used to operate between 8 am to 6 pm compared to 8am to 9pm presently) and remain open on the weekends.

The bank has not had cut jobs in US even as it offshores work to India. Being in a business where the margins are low and processing time and customer service levels are the only differentiators for the brokers, offshoring has served the bank well.

Learnings

Offshoring can deliver a number of benefits beside cost reduction, based on the nature of the business. For time-sensitive operations, the turnaround time can be a substantial gain, by taking advantage of the time difference between onshore and offshore operations.

In an environment of increasing US interest rates and a slowdown in the mortgage market it is likely that the bigger players in the mortgage industry will seek to leverage offshoring in a bid to streamline processes and make business more efficient and provide better customer service. On the other end of the scale, the high interest environment is forcing smaller mortgage brokers, who hitherto were considered too small to take advantage of offshoring, to take a close look at offshoring. The high interest environment will likely see an increasing adoption of offshoring across the board and present new opportunities to service providers and better service to customers.

CASE STUDY 2: PROCESS IMPROVEMENT FOR INSTITUTIONAL BANK

Background

The offshore center of a large institutional financial services company performs functions for all the lines of businesses, and covers all the geographical locations of the bank. Management of the centre realized that for the first time, processes from across the globe were housed under one roof. This presented an unprecedented opportunity to standardize and re-engineer the process.

Offshoring objectives

Besides re-engineering, management established an objective to better utilize the knowledge base that several employees had developed by working in the end-to-end processes, by giving them the chance to run global projects and apply their knowledge to help other teams (often based in the original location in Europe or USA).

Offshoring approach

This resulted in the creation of the Internal Consulting Group. The team was primarily staffed by some of the top performers from various teams, and supplemented by hiring MBAs from top business schools in India. The team provides consulting services in the following areas:

- Business process review and re-engineering
- Strategy development support -- conducting research and making recommendations
- Competitor data and analysis for various business groups within the bank
- Global projects around systems implementations and process re-engineering

The hub in India has been able to successfully create and find a market for a business that did not exist before, by effectively utilizing the talent available in India, and the knowledge base that was developed due to hubbing. It has also enabled the hub to utilize the talent available in India to provide high-value services.

Results

Though the team is small (it comprises of only 25 people, and is expected to remain small) it is now actively managing several projects such as:

- Conducting ‘Activity Based Costing’ studies for various businesses and giving recommendations based on that
- Helping the retail business of the bank create its Asia strategy by researching the market in India
- Providing competitor analysis on a quarterly basis to the investment banking business
- Actively involved in the firms conversion to a new general ledger platform.

These projects have also enabled the team to develop a global footprint.

Learnings

This case study provides a window into the significant non-cost benefits that offshoring has the potential of delivering under the right conditions. In this case, a bank recognized the expertise that was resident in its offshore team, and created mechanisms to deploy it at a global level much beyond the traditional roles and goals assigned to offshoring.

CASE STUDY 3: OFFSHORE HUB FOR GLOBAL BANK

Background

A large global bank set up an offshore hub in India. The hub was set-up primarily to benefit from the cost advantages that offshoring offered – by moving operations to India, the bank aimed to cut costs significantly. The hub mainly performed operations and accounting related functions, such as loan operations, derivative operations, fixed asset accounting, accounts payable and financial reporting, and also had a call center to provide customer service and support.

Offshoring objectives

After initial success, the bank’s management looked to scale up the size of the hub.

Management realized that while good technical talent was available in India, the team lacked the domain knowledge and experience of working in large banks and markets. For example, there were many good accountants, but few who could understand derivative accounting under the US GAAP; there were lots of people with excellent analytical skills, but few who could apply those to the complex products of an investment bank. This was primarily due to the difference in maturity of financial markets in India and the USA.

Offshoring approach

Faced with issues of high attrition, management realized that if they were to successfully manage and grow the center, they would have to work towards creating a sustainable, enduring business – not one that was based on cost reduction alone. By providing opportunities to do high value added work, and to build a career with the bank, in the business of their choice, the management could retain and develop their top talent. Thus, creating a sustainable business model was necessary not only to tide over the immediate issues that they faced, but also to fully realize the potential that off-shoring could bring to the entire organization.

Without a sustainable organization, and one that was integrated fully with the larger global parent, the leaders realized, they faced a risk of creating a mere processing hub. And that could move to another low cost location as India's wage arbitrage advantage declined. Also, without offering the same opportunity to their top talent that anyone else in the bank had access to globally, they were faced with significant issues in retaining top performers and developing the next line of leaders.

To close the gap that existed in domain knowledge and experience of employees working in India, a comprehensive multi-year training and development plan was created. The objective was to provide a framework to employees to develop right skills and knowledge

base to perform their work. A team comprising of college professors, training experts at banks, and process experts were hired to develop this framework. Its development involved extensive analysis of the need, and use of experts to develop content and determine mode of delivery.

Over a 3 year period, an employee was provided a mix of business (banking overview, concepts of finance, advanced product training), tools (advanced Excel and Access, work specific tools) and soft skills (communication, issue resolution and leadership trainings) training. Development of a vast pool of training content enabled the team to tailor the training to the needs of the job and the employee. The hub also partnered with some leading management institutions in India to provide continuing education to employees – thus, a big factor for anyone choosing to work for the Investment bank in India was that they offered tailor made courses with such institutes, which were paid for, and accommodated in the work schedule.

Results

The success of the program went beyond its original objectives. The offshore team that developed the program was charged with undertaking a global roll-out. Currently, the framework is being introduced within various offices in the US and Asia, and a roll-out in Europe is being planned. Now employees in several locations utilize the same training methodology, and content is continually being developed with a global focus. This has enabled standardization of the development programs across the globe, and brought about a structure and framework in the training process, from the earlier practice where this system was very ad-hoc, and depended mainly on the initiative of the individual manager.

The program also had other implications – it provided employees the framework to develop the skills to move into a role/ department of their choice, thus encouraging rotation and bringing down attrition rates significantly.

Learnings

This case study mirrors the learnings from the previous case on the significant non-cost benefits triggered by offshoring. By looking beyond cost savings the bank has been able create impact across the organization through an initiative driven from its offshore center. The significant human resource investment made at the offshore facility, plus the attention given to establishing a high-performance culture in that team – and the consequent benefits delivered by the team on a global scale – is notable.

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- ¹ Projected cash being spent over a period of the time including all the direct and indirect cost
- ² Interview with Dhimant Bhayani, INC3 Capital
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- ⁴ Interview with Carl Everett, Accel Partners
- ⁵ http://www.mckinseyquarterly.com/article_page.aspx?ar=1572&L2=10&L3=53&srId=17&gp=0
- ⁶ Interview with Vik Raina, Boston Ventures
- ⁷ http://www2.chinadaily.com.cn/english/doc/2004-07/30/content_353070.htm
- ⁸ Global Services Sourcing: Issues of Cost and Quality, <http://www.earthinstitute.columbia.edu/news/2004/story07-22-04.html>
- ⁹ Based on interview with Dhimant Bhayani of INC3 and article in VC Journal titled- “ About the India Recommendation” – Nov. 1 2003
- ¹⁰ Interviews with Accel Partners, Boston Ventures
- ¹¹ P/E- avg. price of stock in last twelve months divided by the earning per share
- ¹² <http://yahoo.investor.reuters.com/CompanyFinancialHighlights.aspx?country=US&ticker=NTBK>.
- ¹³ Force multiplier signifies that offshore third party resources can be used without a need for a big capex investment upfront. Case study 3 shows that avoiding a large capex investment was a major driver in the company’s decision to offshore
- ¹⁴ Account receivables which have not gone past the due date
- ¹⁵ Inc Magazine <http://www.inc.com/resources/inc500/index.html>
- ¹⁶ Per hr. pricing is defined as the price charged by a service provider per hour on reaching parameters specified in the Service Level Agreement (SLA).
- ¹⁷ Transaction pricing model is based on the amount being paid per transaction irrespective of the time taken by the service providers to complete that task. In this case the minimum quality levels are defined as part of the SLA’s. As the service providers move up the value chain and gain more experience in certain verticals , we have observed that they tend to migrate to a transaction pricing model from a per hour model.
- ¹⁸ Based on interview with Jeroen Tas - Mphasis
- ¹⁹ <http://www.business-standard.com/ft/storypage.php?&autono=190254>
- ²⁰ Health Care and Mortgage processing requires a lot of personal data like SSN and health care records being handled at offshore locations
- ²¹ Based on interview with Joe Sigelman, Office Tiger
- ²² <http://www.csoonline.com/read/050105/offshore.html>
- ²³ Interview with Alok Agrawal, E-Valueserve
- ²⁴ Refer to the PE Case Study 1 where an offshore research company was used for evaluating a potential investment in US
- ²⁵ Interview with Alok Agrawal, E-Valueserve
- ²⁶ Hybrid offshoring model in this case is where the FSI players outsource non core processes to third party vendors while set up a captive offshore centers for core processes.
- ²⁷ In this model, the facility is owned by the FSI company while the day to day operational management and staff is handled by the third party vendors. Service providers like Office Tiger and Mphasis provide this kind of service for the FSI clients.
- ²⁸ Based on Interview with Hedge fund manager
- ²⁹ In US certain category of mortgage loans are backed by a guarantee against default from Freddie Mac and Fannie Mae which is considered as a quasi sovereign guarantee.