Business Line
INTERNET EDITION
Financial Daily from THE HINDU group of publications
Wednesday, Nov 20, 2002

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eWorld - IT-enabled Services

The ride isn't forever

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eWorld features a new column with this week's article focussing on how soon captive ITES companies ought to grow independent of the parent.

OVER the last few years, there has been a rush among MNCs towards setting up captive ITES companies of their own in India. The economic rationale has been compelling and the positive experiences of the pioneers have encouraged others to follow suit. The landscapes of Bangalore, Chennai and Gurgaon are now dotted with new firms, and the employment pages have started bearing a more healthy look.

But what of the future? Where do these captive companies go from here? We believe that a majority of the current organisations have been set up with a certain set of objectives and that these will need to change over the next five-seven years. Currently, these companies help provide sizeable cost savings to the parent and comfort over the security of their processes. Over the years, however, they will need to move from being cost centres to profit centres. Those that make this shift will thrive and prosper. The ones that don't will probably become redundant and lose their corporate independence. The outcome is predicated on the actions of the current management teams.

Cost vs profit

The fundamental issue with the current structure of most captive firms is that they have been organised as cost centres. This creates its own set of very perverse incentives. Importantly, the cost differential between the West and India is so high, and the likely savings so mouth-watering, that little attention is given to the cost of setting up shop in India. Moving from a Dollar to Rupee cost structure, a 50 per cent saving is reasonably achievable. Most of these companies, thus, have extremely high costs of real estate and wages — two of the primary establishment costs. This is fine in the short term, where the costs are compared to the previous years. However, compared to the cost of operating the processes through a third-party firm, the costs of a captive outfit are high.

And the differential is likely to increase over the years. Three or four years down the road, if a company compared the costs of the captive centre with those of a third-party supplier, it may be tempted to question the rationale for having its own centre.

Poor marketing score

The second big issue is the fact that few of these companies seem to have any semblance of a marketing organisation. Thus a company is dependent on the parent for its revenues — and often carries their name too. As a parallel, few of the captive IT companies could make a successful transition to being third-party vendors (like Citibank). Somewhere down the road, the senior management of the parent company will start recognising the fact that their subsidiary has an untapped business potential. They will ask the management to acquire new customers — and move from being a cost centre to a profit centre. The management, not geared itself for this eventuality, will struggle with its high cost base, lack of marketing skills and the tag of being a captive supplier. It is unlikely, barring a serious makeover at that stage, that it will succeed in its efforts.

Shift in perception

The third factor is one of perception. Today, setting up a captive ITES centre is a safe way for most companies to realise cost benefits while retaining control over their processes. Many of these processes are considered proprietary today and the comfort level of dealing with third-party suppliers is probably low. Over time, this may well change. What is considered proprietary today may become industry standard in a few years. The time spent in India will provide a greater comfort level with the country. Other suppliers are likely to have developed higher capabilities over this period. As a consequence, the need to retain control will diminish.

What all this means is that the relatively high cost of own operations, the inability of the organisation to convert into a profit centre and the reduction in importance of having control will force the parent company to revisit the need for having the subsidiary. The fundamental need for a captive centre will no longer exist.

The way in which this eventuality can be avoided is to factor the above issues at the inception. If the processes outsourced are non-core, a third-party vendor should be considered over a captive operation. MNCs setting up ITES operations should plan for a profit-making independent entity, and not a captive supplier. The costs of operation should be benchmarked with the comparable Indian numbers and not the prevalent US rates.

The firm should avoid being too closely linked with the parent and should have a clear mandate of developing alternate revenue streams.

Management teams that do not address these issues are setting their company up for an eventual sale or merger with another third-party provider.

In contrast, good management teams will work on these issues and will strive to develop a company that is not dependent on the parent.

Once they have crossed the initial hurdles of market acceptance, they will be able to leverage their domain-specific capabilities to grow and prosper. They will have an independent brand identity and a capital market listing. They may eventually become more important to the industry than their parent.

The issues listed in this article are in no way unique to the Indian ITES industry. These are issues that are commonly associated with cost centres and subsidiaries across the world. The key is to recognise that India and the ITES industry are not any different.

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