# THE SERVICES SHIFT

Seizing the Ultimate Offshore Opportunity


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*with* AJAY SHARMA

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# Introduction

If you're an active manager in the first decade of the twenty-first century, you already know about the phenomenon of globalization in the manufacturing sector—although perhaps you don't know the full scope of that phenomenon. But by any measure, it's enormous. In 2006, the U.S. trade-to-GDP ratio was 28.0 percent, compared with 11.1 percent in 1970 and 20.4 percent in 1990.[1] In 2006, U.S. companies committed $60 billion to new manufacturing foreign direct investment (FDI): a jump of *66 percent* over the previous year.[2]

The reasons behind this phenomenon are well documented, and they are widely—often hotly—discussed. They include the low cost of labor overseas, fewer regulatory restrictions, proximity to emerging markets (facilitating sales in those markets), the ability to focus home country resources on product development and marketing, the commoditization of manufacturing technology, the rise of supplier clusters in different countries, and so on.

But there's a parallel phenomenon occurring today—another kind of offshoring—that may soon overtake its manufacturing-based cousin in scale and scope: *the globalization of services*.

We call it "the services shift."

This is a new and different phenomenon, and it's one whose implications are poorly understood by most corporate managers. True, most of us have heard stories about large corporations moving call centers and basic business processes (for example, software development, payroll, billing) offshore. And on a basic level, most of us understand the compelling logic that lies behind these developments. To the customer phoning in to argue about an entry on his or her monthly credit card statement, it doesn't matter much whether the contact center agent is sitting in Omaha, Nebraska, or Bangalore, India. If it's cheaper to hire that agent in Bangalore than in Omaha, *and* if that offshore person is able to resolve the dispute successfully, then that service job is very likely to move offshore.

In fact, to a large extent, it already *has.*

But so far, it has been hard to get a clear picture of what's going on—and where and why. Where are the jobs going? Who's getting the benefits of the globalization of services? How big are those benefits? What companies benefit (or could benefit) from the offshoring of services? How, exactly, does it work? Who makes for a good partner in this realm? What are the public policy implications of this trend—and how can companies make long-term investments if the ground is shifting beneath their feet?

These are the questions we ask and answer in *The Services Shift.*

## Outsourcing and Offshoring

First, some definitions, which we'll return to and flesh out in subsequent chapters. **Outsourcing** means moving a particular task outside an organization's boundaries. When a company decides to eliminate its in-house food service department and hire an outside contractor to run its cafeteria, it is "outsourcing" that function. For lots of "non-core" practical activities—such as staffing the cafeteria and cleaning the headquarters building—outsourcing means buying the service fairly close to home.

But many other activities aren't necessarily rooted in geography. In theory, at least, you *could* outsource these tasks to a contractor anywhere in the world. When a task moves across a geographic boundary, we call this "offshoring."

For example, recent years have seen the emergence of a phenomenon called the "electronic ICU (intensive care unit)"—a virtual ICU that uses video conferencing, remote bedside terminals, and image-acquisition technology to monitor critically ill patients remotely. With eICU, a team of critical-care specialists sits at a remote location and continuously tracks patients' vital signs, and if something is amiss, the team contacts the onsite staff and recommends action.

One electronic ICU provider, VISICU, pitches its product as a way to cost-effectively improve medical care in hospitals that don't have enough critical-care physicians:

> ICU patients require around-the-clock specialized care, however most ICUs don't have the specially trained physicians available to provide this. With an eICU facility linked via telemedicine and computer monitors to their hospital ICU rooms, they now can.[3]

VISICU likens its eICU solution to the air traffic control function, in which a team of technical specialists relies on software and tracking technology to assist in airplane navigation without actually being in the cockpit. The company claims to have implemented some form of the eICU solution in 34 U.S. hospitals, and has recently inked a $25 million deal with Sutter Health, Northern California's leading non-profit provider of health-care services.

Currently, eICU is only outsourced—that is, turned over to domestic contractors—rather than offshored. But in this activity, *distance is irrelevant.* In fact, other than some truly formidable regulatory barriers, nothing stands in the way of moving the eICUs offshore, and thereby substituting foreign health-care technicians for domestic ones.

The white-coated doctor in your local hospital might seem forever immune to offshoring, but as the eICU example illustrates, that's not necessarily the case.

**Offshoring,** as the name implies, means moving a function and its associated jobs to another part of the world. Offshoring comprises a wide range of relationships between the "parent" company and remote service providers. Sometimes those providers stay within the corporate boundary, but operate at a geographic distance. Sometimes they are outside the corporate boundaries (they are "outsourced offshorers"). In this book, we focus mainly on the offshoring phenomenon, although certainly domestic outsourcing is another important kind of "services shift."

The word "offshoring," useful as it is, is something of a red herring. The globalization of services is not simply a story about jobs being moved offshore. It's about a *fundamental reorganization of work,* in which different tasks are being carried out by different individuals in different locations. As new global sourcing options become available, forward-looking managers are actively evaluating tasks, processes, and functions inside their firms—from back-office support to leading-edge research—to determine the most cost-effective *and* highest quality location to carry out these activities. In other words, it's not just about finding a low-cost location. It's about gaining access to the best combination of talent, resources, and local markets.

Why is it happening *now?* Again, we'll look into this question in greater depth in later chapters. But for now, we'll simply point to five compelling forces:

- **Technological innovations—**These innovations include the spread of computer literacy, broadband Internet access, inexpensive international telephony, widespread digital records, and so on.
- **Emerging market growth—**Today, developing countries are working to "grow" their service sectors at least as aggressively as their manufacturing sectors. Countries around the world have witnessed India's experience—with exports of software and IT-enabled services growing at a compounded annual growth rate of more than 43 percent, rising from $128 million in 1991 to $40.8 billion in 2007.[4] These exports can be achieved with relatively low capital investment and environmental impact. Finally, the sector is attractive because it involves using a country's brains, not its brawn.

- **Global macroeconomic liberalization —**Based on the standard measures of economic "openness," more countries are able to engage in international trade and investment than ever before.
- **The corporate imperative to both reduce costs and improve quality—**Most business practitioners understand the concept of lower cost through offshoring; fewer understand that offshoring can lead to major productivity and quality improvements.
- **A convergence of global business culture**—This includes the global dissemination of Western management principles, the emergence of English as the global language of business, and so on.

Even this brief review of the factors pushing for the globalization of services should suggest, *strongly,* that this powerful trend is not a fad, but a huge, fundamental, and irreversible shift. According to McKinsey/NASSCOM, offshore IT and business process outsourcing (BPO) have only reached *one-ninth* and *one-twelfth* of their respective market potentials![5]

What does this mean for your company? Business models and organizational structures will become more dynamic, more fluid, and more opportunistic. In fact, this transformation is already well underway.

What does this mean for *you?* Tomorrow's managers also will have to become more flexible, more versatile, and more broad-gauge. The old ways of providing services—both in the traditional "service sector" and in the services-oriented activities of manufacturing firms—just won't cut it in the face of the global services shift. You need to understand the offshoring options that are available to you, because—*without a doubt!*—your strongest competitors will certainly understand them, and exploit them.

## Introducing the Authors

Who, exactly, is taking you on this global tour of offshoring? As much as possible in this book, we'll adopt the first-person plural voice: *we.* For the purposes of this part of the introduction, however, we'll switch briefly to the third person.

Author **Robert (Bob) Kennedy** is the Tom Lantos Professor of Business Administration and Director of the Global Initiative at the University of Michigan's Ross School of Business. He is also Executive Director of the William Davidson Institute (WDI): an independent, nonprofit research and educational institute located at the University of Michigan. Founded in 1992, the Institute focuses on business and policy issues in developing countries and operates in five broad areas: research, executive education, development consulting services, development and distribution of teaching materials, and supporting international activities at the University of Michigan.

Kennedy has been involved in research and advisory work directly related to offshoring for the better part of a decade. In 1999, he began working with Tata Consultancy Services, which is India's largest software firm, and one of the leading global drivers of services offshoring. Since then, Kennedy has published more than a dozen teaching cases on offshoring issues. Between 2002 and 2008, his international business and offshoring cases were assigned at every one of *BusinessWeek*'s top 25 business schools.

In addition to his academic credentials, Kennedy has extensive "real-world" experience. He has worked as a consultant in more than 20 countries, performing advisory work for many of the firms engaged in cutting-edge offshoring practices. Prior to his academic career, he worked as a venture-capital investor in central Europe and has maintained this real-world orientation ever since.

Coauthor **Ajay Sharma** is Research Manager for the "Globalization of Services" initiative at the William Davidson Institute, and is an expert in IT and process consulting. After earning his bachelor's degree in electrical engineering at the Institute of Technology, Banaras Hindu University (Varanasi) in 1992, he joined Infosys, which was then embarking on a dramatic growth curve based on offshoring software development. After six years as a project manager with Infosys, Sharma joined PriceWaterhouseCoopers (USA), where he provided technology consulting to Fortune 500 companies. He then earned his MBA at the University of Michigan, and—after receiving his degree in 2004—joined the William Davidson Institute.

Returning to our shared authorial voice, together we have deep theoretical grounding, extensive practical experience, and strong ongoing relationships with many of the most innovative offshoring companies in the world. It's this knowledge base and experience that we bring together in *The Services Shift.*

## What You'll Find in This Book

We've already introduced the important distinction between outsourcing and offshoring, mainly talking at the industry level. In Chapter 1, "Globalization of Services: What, Why, and When," we'll dig deeper into these phenomena, giving examples at two levels: industries and companies. We'll provide several tools for you to use as you think about your own company's place in the global services community. We'll explain that the current (and exploding!) wave of services globalization is simply the next logical step in the evolution of international trade, which began with the extraction and exploitation of natural resources, continued through the rationalization of manufacturing around the world—a process that continues today—and now is expanding rapidly into the services sector.

We economists sometimes take for granted certain theories and principles that business practitioners, pundits, and laypeople either don't understand or simply don't buy into. With that potential gulf in mind, we provide some basic economic rationales for why international trade and investment are "good," in the sense of creating comparative advantages for nations, and better returns on capital for individual investors.

Yes, change inevitably causes pain and dislocation for workers in particular industries or sectors. One of the paradoxical aspects of globalization is that the *gains* it creates tend to be spread across large numbers of individuals, whereas the *pain* it generates tends to be localized in smaller groups of workers, companies, or communities. When millions of Wal-Mart shoppers save $10 each on their running shoes, that's a huge collective benefit to those shoppers. Meanwhile, a running-shoe factory closes somewhere in the United States, creating dislocations and pain for the people who worked in that factory, and for the surrounding community. When viewed systematically, in almost all cases, the total gains from trade outweigh the losses. It's just that the losses are more easily identified and observed.

The domestic U.S. press has taken notice, often casting this phenomenon in terms of "American jobs lost." But this is the wrong lens through which to observe trade. The right question is, *where can and should specific tasks be located to achieve the best combination of cost and performance?* Yes, the jobs that are associated with these tasks might move. But locating *the right tasks in the right place* also leads to faster product development, stronger companies in the "offshoring" nations, better returns for investors in those companies, and rising demand in those nations.

In other words, offshoring—done right—leads to an enhanced standard of living in both developed and developing countries. To be sure, change is uncomfortable, and this provides a ready hook for polemicists. But change is also necessary for growth and improvement.

As we make clear in Chapter 1, managers don't have the luxury of putting their strategies on hold to await the outcome of a national policy debate. They have to improve their firms *today,* along lines that have already been proven to work, or they will fall behind to those who *do* make those compelling changes.

Chapter 2, "The Economics and Drivers of Offshoring," provides a framework for analyzing and understanding offshoring opportunities and discusses why the globalization of services is occurring *now.*

In the first part of Chapter 2, we look briefly at two economic frameworks that are helpful in understanding and assessing offshoring opportunities. The first is the value chain, introduced by Michael Porter in 1985. The value chain framework allows the analyst to look inside the "black box" of a firm—breaking it into a sequence of functions or tasks. Porter's insight was that competitive advantage arises from capabilities at the *function/task* level, not at the *firm* level.

The second framework is "transaction costs economics," or TCE, which explains why and where firm boundaries exist. This, in turn, helps shed light on why firms perform some tasks themselves locally, "outsource" some tasks to other firms, and source some from remote locations. As businesses, suppliers, customers, and technologies evolve, the transactions costs involved in moving tasks across firm or geographic boundaries also change, thus affecting the sourcing options and payoffs facing firms.

The chapter then revisits the outsourcing/offshoring decision and, using TCE, discusses the factors that make a task more or less likely to be a candidate for being transferred across a firm or geographic boundary.

In Chapter 1, we explain why trade in services has become more like trade in manufactured goods in recent years (production and consumption have become separable by geography). In Chapter 2, we show how trade in services *differs* in important ways from trade in manufactured goods.

Why? First, services tend to be much more labor intensive than manufacturing. This means that low-wage countries have an even greater advantage in services than they traditionally have had in manufacturing. Second, new (and vocal) categories of workers have become vulnerable to offshoring. Third, trade in services tends to be *synchronous*—that is, happening in real time—which makes this new kind of trade highly visible. And fourth, within the firm, offshoring tends to happen at the task level, and activities sourced remotely remain closely connected to activities retained at home. This means that a service activity that has been offshored—for example, accounting, collections, or product design—still interacts with the company's remaining employees every day.

Still, not all services lend themselves to offshoring. There are still whole categories of jobs that will remain off limits to offshoring, at least for the time being—and in some cases, forever. (Your local barber, your police officer, and your elementary school teacher are probably immune to offshoring.) Certain kinds of jobs near the beating heart of the company—the core competencies—are probably "safe." But changing technologies call for a continual reexamination of what is possible. Radiologists once assumed that they were safe, and it's now clear that they are not.

The chapter concludes with a discussion of what we call the "Five Drivers of Globalization" in the services sector, and explains why those drivers are likely to intensify in the future:

- The economic liberalization in developing countries, which has resulted in 1) lower barriers to economic engagement, 2) higher growth rates in those countries, and 3) increased attention from global firms that are under pressure to generate higher growth rates of their own
- The digitization of business processes, which makes many more business activities "moveable"
- Rapid improvements in quality and reductions in cost across a range of computing and telecom services, which again permit and encourage "task mobility"

- Growing capabilities around the globe
- The emergence of a global business culture, based largely on the practices of leading U.S. and European companies, which makes an ever-larger number of geographic contexts congenial to those companies

In Chapter 3, "Making It Real," we present a framework intended to help you establish realistic sourcing goals for your organization and to implement these goals. Firms pursue offshoring for a variety of reasons, including efficiency, enhancement, and transformation. The first part of the chapter discusses how these approaches differ and why it is imperative that you be clear and realistic about establishing your offshoring goals. These goals influence the entire offshoring journey—which tasks/processes to start with, the type of sourcing partner to work with, the risks encountered, and the expected benefits.

The chapter then discusses the differences between offshoring tasks (for example, operating a call center and managing accounts payable) and offshoring entire processes (for example, hire-to-retire HR management or purchase-to-pay sourcing operations). Task offshoring tends to be cost and best-practice focused, whereas process offshoring is closely linked with reengineering. In some situations, successful process transformation leads to business performance benefits of 10 to 20 times those from labor cost savings.

The chapter then describes in detail how companies go about identifying, documenting, and migrating activities offshore. We walk you through an eight-step process that takes companies from activity identification to implementation, calling on tools such as detailed process mapping, IT systems implementation, risk mitigation, monitoring, process migration, and post-switchover integration.

Let's assume you're interested in offshoring, but you're not sure of your range of choices in the global marketplace. Chapter 4, "The Supply Side," explores outsourcing options today. It begins with an overview of the offshoring universe—size, growth rates, types of activities, and so on. The chapter then discusses how we got here—starting with the Tata Group's initial software exports in 1973 and continuing (in a milestone format) up to the present.

We then present a typology of offshoring business models:

- The captives of global firms such as Motorola, American Express, and Microsoft
- Organizations affiliated with global outsourcing firms, such as Accenture, IBM, and Convergys
- Firms affiliated with offshore software firms, such as TCS, Infosys, and Wipro
- Independent firms, such as ITTIAM, EvalueServe, and Teleradiology Solutions, Inc.

Obviously, offshoring involves all different kinds of firms. Yes, you have the huge software firms that have gotten into the back-office business. And you have the U.S. Fortune 100 firms that are rushing over in large numbers, as well. (IBM now has 53,000 people, or 17.6 percent of its global workforce,[6] in India, and has described India as a linchpin in its strategy to serve the "globally integrated enterprise.") But you also have a host of very small firms in niche roles—market research, medical transcription, and so on. You also have reconfigurations within this cast of characters—for example, GE's spin-out of Genpact (from captive to independent), and R.R. Donnelley's recent acquisition of Office Tiger (from independent to captive).

Today, much of this activity is centered in India. But more and more countries are playing, or trying to play, in the offshoring game. China and the Philippines are already important offshore destinations, and countries such as Hungary, Russia, Morocco, Brazil, South Africa, and Mauritius are gaining ground.

What do these different kinds of firms, in their different geographies, mean for *you,* as a contemporary manager? How do you choose a partner, and what signals should you look for in a successful offshoring relationship?

Chapter 5, "Shifting Skill Sets," explores what this all means for how you manage and organize your firm. We start with the fact that offshoring is a *hands-on activity.* Moving tasks from one geography to another creates both enormous challenges and impressive opportunities for companies. Managers need very specific skill sets to make offshoring work—and those skills often differ from those required in the non-outsourced, non-offshored world.

For example, international skills (language skills, cultural awareness, an understanding of how the global business community functions) were once a "nice to have." Today, for offshoring companies, they are indispensable resources. Where such skills were once confined to the executive suite or in the "international division," they are now required deep down in many different parts of the offshoring organization. At almost every level, people need to understand how to communicate and manage across cultures. They need to be skilled at anticipating and managing risk, and they need to be effective communicators—enabling them to head off the backlash that is often inherent in offshoring, or to contain and offset that backlash when it does arise.

At the same time, strong IT and industrial engineering skills are needed—not only to reengineer, migrate, and manage far-flung operations, but also to develop and maintain the IT systems that are required to manage a geographically dispersed operation.

The chapter presents a framework with which to consider the types of management responsibilities that lead to success. We then draw on detailed interviews with dozens of offshoring firms to illustrate how the key success factors for managers change when an organization embraces global sourcing.

From the opening chapters of *The Services Shift,* we underscore our political agnosticism about offshoring. Because there's no point in arguing with the tide—we assert—managers should focus on *understanding* and *exploiting* this growing trend. In Chapter 6, "The Services Shift: Policy Implications," we adopt a broader policy perspective. Offshoring has led to a flurry of policy initiatives, in both developing and developed countries. What are the general approaches, and what do these mean for managers?

In developing countries, policies have focused on investment in education (sometimes primary, and sometimes advanced technical), telecom deregulation, export-processing zones, general incentives for foreign investment, and—in some cases—a broad-based reform of the commercial code. Obviously, these policies are intended to be "offshoring friendly," and many have proven very successful.

In the developed world, most policy initiatives are aimed at slowing or regulating the offshoring choice. In the United States, for example, at least 33 state legislatures have debated anti-offshoring legislation, and the U.S. Senate has actually passed laws setting limits on offshoring. We argue that for at least three reasons, these policies are generally misguided, in both the short and long term. First, as noted earlier, the savings associated with offshoring tend to be so huge, and companies are under such extraordinary pressure to improve their margins, that managers have little choice but to seek out these opportunities, even when they are frowned upon in the political arena.

Second, the offshore migration of activities is simply too hard to spot to allow for effective regulation. Even when governments try to regulate offshoring, they have almost no ability to monitor, much less enforce, such regulations. Moving a 250-person factory is one thing; moving four customer-care positions or hiring an engineer in China (even though one was available in Michigan) is quite another.

Third, as explained in Chapter 1, all the evidence suggests that for the developed world, inhibiting offshoring only *reduces* long-term incomes. Countries that open up their economies tend to grow faster; countries that throw up protectionist walls tend to grow more slowly. Anti-offshoring policies may be politically appealing in the short term, but they are a bad economic prescription for long-term growth or high standards of living.

The only feasible policy responses to the pain and dislocations caused by offshoring—we argue—are to focus on 1) minimizing costs to affected workers, and 2) hastening their transition to new sectors. Much has been made in the U.S. media about transition and adjustment programs that haven't worked. We point to examples of adjustment processes that *are* effective and *do* add value.

And finally, in Chapter 7, "Looking Ahead," we look to the future. What is the next big thing in the globalization of services? And what does that mean for managers today?

First, we reiterate some of the points made in earlier chapters. Offshoring will become a much more truly global activity. Other countries will "gain on" India as they figure out their own unique niches and competitive advantages.

Second, globalization will come to many more services—both high value added (R&D, product design, legal and advisory work) and more personalized services (tutoring for your child, life coaching, personal scheduling).

Third, globalization of services will grow strongly in the non-IT realm. Instead of servicing clients from a distance, new firms will bring clients to the developing world. We are already seeing the beginnings of this trend with so-called "medical tourism" and retirement communities in low-cost countries.

Fourth, business-process multinationals will play an ever more important role. Companies such as Tata Consultancy Services, Infosys, Wipro, and Genpact are growing at astounding rates; all are likely to have more than 100,000 employees within a few years. They will be well positioned to offer the equivalent of "standardized parts" for knowledge work.[7] As this happens, ever-greater numbers of firms in the developed world will be compelled to conceive of their traditional back-office processes as standardized utilities.

Introductions have their perils. Boiling down the contents of our book into a few short pages—as we've tried to do here, to give you a sense of what's coming—leads to a pretty dense result. Don't be daunted; in subsequent chapters, we will do our best to make sometimes-complicated ideas accessible, and *useful.* The services shift is creating an enormously fertile ground of opportunity; our goal is to make you feel at home on that ground.

# Endnotes

[1] The trade-to-GDP ratio is calculated as (exports + imports) / GDP. It provides a rough measure of the role trade flows play in an economy. Source: Economic Report of the President: 2008, Table B-1.

[2] Peter Koudal, "Growing the Global Corporation: Global Investment Trends of U.S. Manufacturers," Deloitte Research, 2005.

[3] Company Facts, VISICU, http://visicu.com/index_flash.asp (accessed on February 21, 2008).

[4] Data from "NASSCOM Strategic Review" (2008) and from "Tata Consultancy Services: High Technology in a Low-Income Country" (2000), by Robert E. Kennedy, Harvard Business School Case # 700-092.

[5] "Nasscom-McKinsey Report 2005: Extending India's Leadership of the Global IT and BPO Industries," NASSCOM, December 2005, p. 30, 33.

[6] Paul McDougall, "IBM Head Count In India Tops 50,000," *InformationWeek* (Feb 2007), www.informationweek.com/story/showArticle.jhtml?articleID=197002525.

[7] I first heard this phrase from John Sviokla, a former colleague at Harvard Business School and currently Vice-Chairman and Director of Innovation and Research for Diamond Management, a leading technology strategy consulting firm.

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