

**CRISIL Young Thought Leader 2009**

***Are captives better than third party KPOs?***

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## ***Executive Summary***

In this current era when the world is becoming more and more knowledge and information intensive, KPO or Knowledge Process outsourcing has become the next biggest concept in the corporate world. KPOs deal with high-end business processes which require strong analytical and decision making abilities.

This report outlines the basic difference between a KPO and a BPO (Business Process Outsourcing) and then goes on to analyze the two-important business models that are prevalent in the KPO industry—Captives and Third-party Outsourcing.

Further, it details the advantages and disadvantages that a captive KPO has over the third-party service providers. This comparative analysis takes into consideration the growing competition in the global KPO market and the growing preference for India as an outsourcing hub.

Moreover, it describes a robust business model which will help the captive KPOs overcome the potential threats and ensure that they retain the economic advantage over the option of outsourcing to third-party vendors. The people management issues, which are keys to the success of a knowledge intensive industry like KPO, are addressed in the last section of this report.

### **What is KPO? How does it differ from a BPO?**

What a layman perceives is that **Knowledge Process Outsourcing (KPO)** is one step extension of Business Processing Outsourcing (BPO) because BPO Industry is shaping into Knowledge Process Outsourcing because of its favorable and advantageous future scope.

But, it should not be always treated as a 'B' replaced by a 'K'. KPO differs significantly from BPO in many a ways.

- In BPO the focus is on execution of standardized, routine processes. In contrast, KPO requires carrying out customized processes that demand advanced information searching along with superior analytical, interpretation and technical skills, as well as some judgement and decision-making. On the whole it can be said that BPO is rule based where as KPO is judgement based.
- BPO provides process expertise where as KPOs focus on domain expertise.
- KPO involves processes like valuation research, investment research, patent filing, legal and insurance claims processing, etc. which are high-end and require specialization and competence to a great extent. On the other hand, BPO generally concentrate on low-end automated processes.

The following table shows the different processes across various segments which are generally performed by a KPO player.

<b>Segments</b>	<b>Processes</b>
<b>Law</b>	Contract drafting and management, litigation and document analysis, legal and patent research, analysis and prosecution-related services
<b>Pharmaceuticals</b>	Pre-clinical studies, bio-availability, bio-equivalence, clinical data management
<b>Animation</b>	Pre- and post-production activities
<b>Research and analytics</b>	Business research, market research, IP research, financial and data analytics, investment research, emerging markets research

<b>Learning</b>	Private tuition
<b>Health</b>	Non-invasive imaging studies, CT, MRI, ultrasound, digitized X-rays
<b>Investment and equity research</b>	Contract research for investment banks, corporate banking support, equity and fixed income research

KPO being significantly different from a BPO needs to be analyzed in detail regarding the processes that are followed and the different business models adopted.

### ***KPO Industry Scenario***

#### **World**

It is predicted that revenues from the KPO market will grow globally from USD 1.29 billion in FY 2003, to USD 17 billion in FY 2010. This implies a CAGR of 44.5 percent, for the global KPO market.

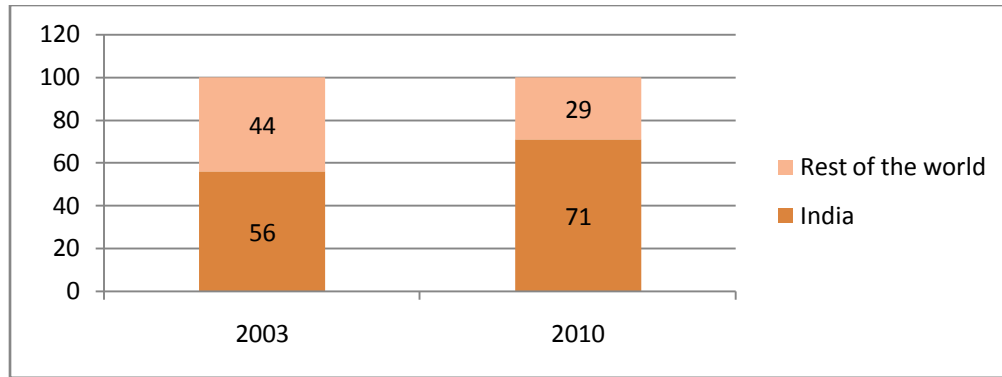
The important growth drivers of this market are:

- The quantum of savings possible of concentrating on the high-end of the business is much more as compared to the low-end of the business. Hence companies are eager to build capability in KPO
- The availability of cream talent in the developing countries at a very cheap rate as compared to the western countries

#### **India**

According to a report published in 2007 by Evalueserve, the Indian KPO sector will keep on increasing its share in the global KPO sector and would reach an enviable state of 71 percent by 2010, compared to a 56 percent share in 2003. The KPO market in India is expected to increase to USD 12 billion by FY 2010, reflecting a CAGR of 49.5 percent.

The following graph shows the potential growth in the share of the Indian KPO Sector as a percentage of the Global KPO Market:



### **Different models of KPO**

Any company that operates in the manufacturing or the services sector viz. Telecom, Banking, IT etc. needs to use the services of a KPO. The objectives that drive the decision of the business model for the KPO is in line with gaining maximum advantage, i.e.

- Saving money by lowering costs
- Improving the quality of the service provided

But the real decision as to which business model is adopted depends on several other factors which are strategic in nature. There are basically three broad models followed by the KPOs all over the world:

- **Captive KPOs:** the offshore units of the parent organization dedicated to KPO
- **Third-party outsourcing:** Pure-play KPO players who provide services to firms across all domains
- **Hybrid Model:** A complex model involving both the captive component as well as third-party vendor interaction

### **Current breakup of the KPO firms**

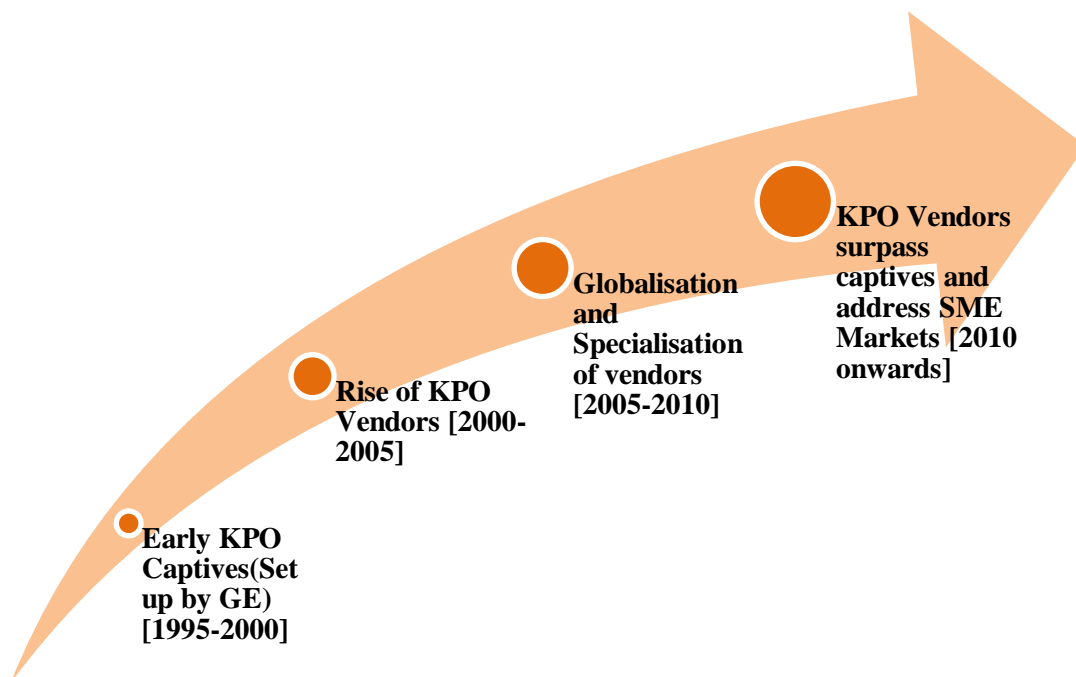
Currently the captives outnumber the third-party pure play KPO providers by a considerable margin. Most of the companies are keen to reap the benefits of outsourcing but at the same time they are not willing to expose themselves to the inadvertent risks in third-party outsourcing such as patent theft, copyright infringement etc. Hence they have taken the captive route. This enables them to protect themselves against possible IPR threats and feared loss of patented material. These captive KPOs are expanding their India presence:

- Google has set up its second research center in Hyderabad; the first center is in Bangalore.
- Goldman Sachs is expected to grow its India headcount to reach employee strength of approximately 2,000.
- JPMorgan Chase plans to double its headcount in India from the current 3,000.

### Anticipated Growth of KPO Industry in India

According to the EValueserve study in 2007, the development of the more nascent Indian KPO industry is showing very strong similarities to that of the IT industry. Both offshoring industries started with captives and in time saw the emergence of vendors. There are even some indications that the KPO industry is developing more quickly than the IT industry did ten years ago, since the fundamental business model of offshoring was already established, when KPO started. However, the average deal size in IT is bigger than in KPO, which implies more complex and distributed marketing and sales in KPO thereby neutralizing the above effect to some extent.

The figure below shows the growth trajectory of KPO Industry in India



## **Differences between Captive KPO and Third Party Outsourcing**

The key factors that influence the decision of the company to go for a captive centre or Third-Party outsourcing with respect to KPO services is shown in the table below:

### **Captive Center**

- Guaranteed long-term specialized resource requirements
- Predictability of growth and retraction
- Decision to deliver any of core services using remote resources
- Desire to reap true cost benefits of having own operations in lower cost locations
- High levels of IP and business knowledge sensitivity
- Desire to have direct control over remote team
- Need to build and retain specific domain knowledge
- Existence of strong delivery processes in the parent organization
- Readiness for internationalization and localization of business management
- Preparedness for the capital investment
- Commitment to putting effort into managing team of the captive center and integrating it into the organization
- Desire to gain long-term efficiencies not only for software development but also for support, maintenance and other functions
- Regulatory constraints that prohibit outsourcing of processes

### **Third-Party Outsourcing**

- Irregular but on-going projects or one-off projects
- Carefully and extensively defined requirements and deliverables
- Readiness to invest time in clarifying specifications and managing change requests
- Gain operational flexibility (quickly free up internal and ramp-up or ramp-down external resources)
- No or insignificant IP and business knowledge sensitivity
- No long-term commitment
- Access to specific technology or domain expertise and best practices that are not available in-house
- Desire to have external vendor manage non-core or non-critical activities
- Little to no specific infrastructure requirements
- Low learning curve is required for the activities to be performed by remote staff

## **Advantages of Captives**

- **Perceived better control:** In case of a captive KPO all the employees work under the same roof and strive for the goals set by the company. Hence there is no threat of a potential conflict of interest among the KPO employees and those involved in other processes.
- **Management style and culture:** The organization can retail its culture and management style by off-shoring its captive unit. This reduces the burden on the company as far setting new processes and adapting to the work culture of the vendor is concerned.
- **Security:** Several companies have high-security data which is required by the KPO. Building a captive eliminates the threat of leakage or mishandling of this secure data.
- **Flexibility:** The need for a Service Level agreement with a vendor is ruled out. Hence the company can directly enforce any process change as and when necessary.
- **Cost control:** Captives adopt the best practices of the economic processes and are highly cost effective

## **Problems with Captives**

Some of the key challenges that combine to stunt productivity and performance of a captive KPO are:

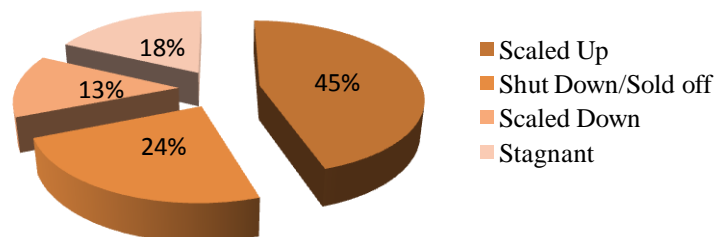
- **Lack of Scale:** Scale of operations is the most important parameter determining the success of any company. But very few captives can achieve a high scale. Generally 500 resources (employees) is the magic number for the efficiency of a KPO firm. But very few captives achieve that figure.
- **Higher Than Anticipated Costs:** Many companies don't pay premium salaries to attract top talent in their captive KPO units. Desperate to scale up, captives often pay well above market rates throwing the entire cost model out of whack. This is a serious demerit of the captive model especially hurting the start-up units which operate on a shoe-string budget.
- **High Attrition:** High attrition is a major deterrent which kills productivity and at the same time destroys morale of the resources. Industry statistics show attrition at captive centers is almost twice as high as the average rate for the third-part providers. There are several factors that drive attrition:

- There is sense of lacking as far as career path opportunity is concerned, especially at smaller captives
- **Second-class-citizen status:** In many cases off-shore teams at the captives are considered as second class employees doing uninteresting work that is not important to the main function of the organization
- **Poor Development Process and Integration:** Many captives face a lot of difficulty in establishing strong development processes. Similar problems are faced while implementing productivity improvements. Ability to integrate rigorous procedures like CMMi, Six Sigma and other measures into practice are seldom found in the captives. Further they often lack proven processes for knowledge transfer and collaboration. All of these things and more have a direct impact on the productivity of a global operation.
- **Management Attention Wanes:** The management team is initially excited about the captives. But it is generally observed that the management support and the enthusiasm are very short-lived. It is highly essential for the captive model to be experts in managing their operations without diverting attention from the core focus of the company. This is possible only through robust management support.

### Failure of captives

Over the last few months the pace of decline of captive KPOs has been hastened by the global recession. Many firms that were under tremendous pressure to perform let go of their underperforming captive centres in order to lessen the burden on financial statements which were already in the reds. Apart from monetization of assets, this also helped the firms to focus on core activities.

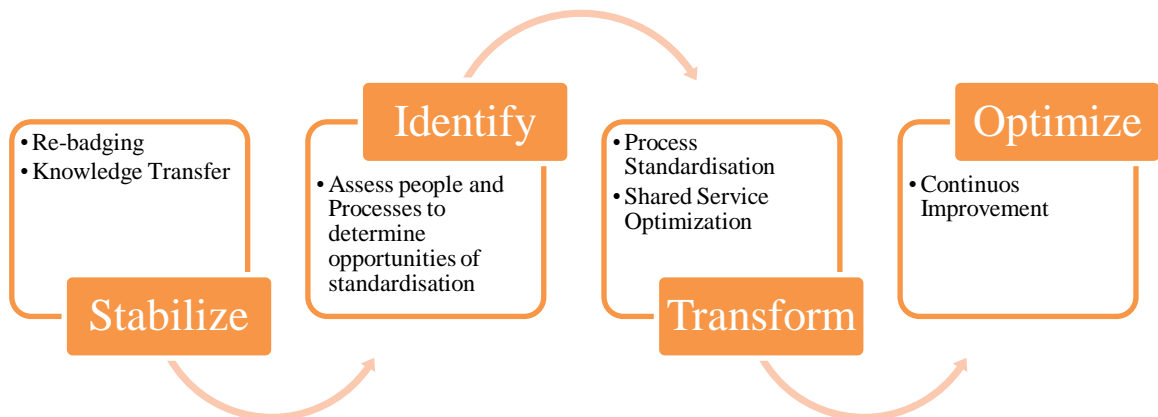
The following graph shows the relative number of KPO captives in India that were under pressure last year:



## Options ahead for the Captives

When a captive is underperforming, then there are several factors responsible for it and steps need to be taken to ensure that the loopholes in the captives are eliminated and it ensures a robust model that is sustainable and efficient. The main options available are:

- **Reinvest and Renew:** This approach is viable only when the company is confident of reviving its captive unit by achieving the required scale of operation. This can only be followed by companies which are typically large in size and are very much concerned with the security of their data.
- **Standardize Operations:** In the KPO industry, the players especially captives have to move from providing great insights/ R&D, etc, to a model where they develop proprietary, yet repeatable properties. This is a challenging task but this needs to be done to sustain the captive. A sample roadmap illustrating this is shown as below:



- **Adopt a Hybrid Approach:** A hybrid strategy can be adopted where the captives can start working with a third-party provider or a group of providers to enhance their output. There are almost no large Captives that do it all in house.
- **Turn Offshore Operations over to a Provider:** This sounds the most radical, but sometimes is the best solution. This is an emerging trend with underperforming captives whereby they transfer operations to a provider. When the issues around scale and

productivity are considered that are challenging Captive performance – and further factoring in the dramatic increase in R&D expenditures by bringing all of those resources back onshore – it is at least an option worth exploring before a decision is made to otherwise just shut down the Captive.

- **Close up shop:** This should be the end resort of the company when the cost over runs exceeds the threshold and the company can no longer sustain from the future cash flows.

### **Suggested Business Model**

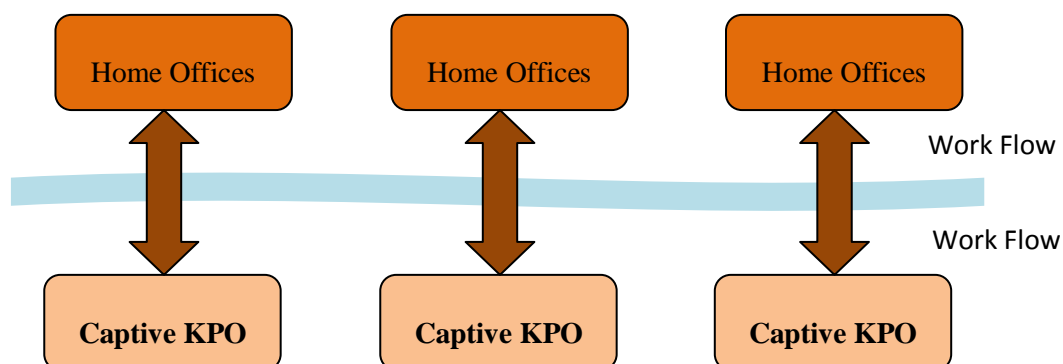
Captive KPO units have become a strategic tool for maintaining competitiveness. Therefore, operation models and the efficiencies of the captive units have become a decisive parameter based on which the parent companies decide the investment decisions and future of their captive offshore units. The following models are developed for such captive KPO units taking into account cost consideration, operational efficiency and sustainability.

### **Dedicated Teams Model**

As it is evident from the name, offshore offices may have a structure comprising teams that are dedicated to the departments or divisions or offices in different geographical locations and their working, utilization, team-building, career development and training depends on these onsite entities to which they are bound to.

The model is highly effective in cases of work that are knowledge intensive and involve higher levels of communication. Hence this is suitable for a captive KPO. In such units Teams can develop into research support, in client specific needs as well as for product development and exploring new opportunities. Jobs in such offshore units bring about specialization and growth of the human resources in their chosen fields. Because of close knit ways of working with the home units, the teams develop good inert personal skills and the resources do not remain faceless as can happen in cases of other models.

The business model is shown in the following figure:



## People management Issues

The captive KPOs also need to take care of the HR issues.

- The entry-level job in such organizations, as against a typical BPO/call centre, requires both analytical and judgmental capabilities and also domain expertise. Attracting talent and retaining it then creates numerous challenges.
- Highly qualified manpower is available in India. However, the required capabilities for working in such a knowledge-intensive and global environment are not uniformly distributed across this population. Given the “variability of quality”, it becomes a huge challenge to identify and then attain appropriate personnel for the organization.
- A rigorous and structured recruitment and selection policy needs to be put in place by the captive KPOs.
- Another key challenge is to retain such potential resources by creating a work environment that provides sufficient opportunities for learning and a reward system based on a transparent performance measurement system.

## Conclusion

If the captive units, even though they are of the smaller organizations without having the advantage of scale, follow a robust model as described in the report and more importantly focus on recruiting and retaining top talent, then they would be able to harness the benefits to the maximum possible extent without having to worry about the risks and threats related to the leakage of their intellectual property.

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## Profile

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## EDUCATION

<b>Indian Institute of Management, Lucknow</b>	<b>PGDM (Finance and Marketing)</b>	<b>2008-10</b>
<b>National Institute of Technology, Rourkela</b>	<b>BTech (Mechanical Engineering)</b>	<b>2004-08</b>

## ACADEMIC ACHIEVEMENTS AND AWARDS

- Placed 4<sup>th</sup> among 30000 students in the Higher Secondary Examination conducted by Council of Higher Secondary Education, Orissa.
- Ranked 6<sup>th</sup> in Junior Mathematics Olympiad, 1999.
- Ranked 12<sup>th</sup> in Regional Mathematics Olympiad, 2003. Selected for **Indian National Mathematics Olympiad 2004**.
- Awarded the **Honours** degree by **NIT Rourkela** for excellent academic performance during under-graduation.

## PROJECTS AND PAPERS

- Completed a **live project** for **FISME, Govt. of India**.
  - Study** of SME Sector and Export Credit Policy of Brazil.
  - Comparative analysis** of Indian Export Credit policy and recommendations for improvement.
- Executed a **live project** for **LeBooks**.
  - Study of the online book retailing business in India
  - Proposed promotional methods** for the website through tie-ups with book-lover networks and bloggers.
- Completed a project “**Analysis of the Risk Profile, Capital Structure, Dividend Policy and Valuation of select listed firms in the FMCG Sector**”
- Built a **financial model** for “**Forecasting the Working Capital Requirement of the firms in the Indian Textile Industry**”
- Completed a study on “**Micro-economic analysis of Mobile Value added services Industry in India.**”
  - Analyzed the Demand-Supply in the VAS industry, the different segments of Market and established a correlation between the income of a segment and the demand.
- Published** an article in “*The Financial Express*” titled “*Post-Lehman World: Is there any room for marketing derivatives?*”
- Presented** a paper titled “Increasing the efficiency of CMM” during the **annual technical symposium** of NIT Rourkela. One of the 5 finalists from over 100 entries.

## POSITIONS OF RESPONSIBILITY

POSITION	ACCOMPLISHMENTS
<b>Coordinator, Team Oculus-</b> The Communication Platform of IIM Lucknow.	Responsible for <b>sponsor management and print communications design</b> for annual national level event – <b>Ocumen</b> . Conceptualized & launched <b>Wordsmith – a content development initiative</b> providing students series of live projects for business clients on a demand basis. <b>Content designer</b> for the college newsletter, <b>IIMPulse</b> .
<b>Editor, Renaissance-</b> NIT Rourkela’s <b>Mouthpiece</b> <b>Editor, Cyborgs-</b> <b>Technical Bi-monthly,</b> NIT Rourkela	<b>Pioneered a feedback system</b> to gauge the readers’ perception of the publication. <b>Conceptualized the entire lay-out</b> of the paper. <b>Managed the publication funds</b> for Cyborgs.
<b>Secretary – Robotics and Aero-modeling Club,</b> NIT Rourkela	<b>Planned and organized</b> the <b>robotics</b> events at Confluence 2k7, the <b>annual technical symposium</b> of NIT Rourkela. <b>Conducted</b> aero-modeling workshops at different schools of the city.

## EXTRA-CURRICULAR ACTIVITIES AND ACHIEVEMENTS

<b>Campus Winner</b> <b>Mahindra War Room</b>	Winner of the campus Round of Mahindra War Room, a national level competition. Suggested a strategy for M&M to foray into the 2-Wheeler Sector
<b>Zonal Finalist</b> <b>GSK Stratedge</b>	One of the 6 teams selected from more than 40 teams from the north-zone. Presented a rural marketing strategy for the products of GSK.
<b>Runner-Up</b> <b>P&amp;G CMK Case Game</b>	Runner-up in “ <b>Consumer and Market Knowledge (CMK)</b> ” case game organized by <b>Procter &amp; Gamble</b> at IIM-Lucknow, Sept 2008
<b>Winner</b> <b>White Paper Contest</b>	Winner of the White Paper Contest organized by Consult and Strategy Group, IIM Lucknow. Authored a <b>white-paper on “Indian Railways”</b>