



DIGITAL & TECHNOLOGY SERVICES

The Disruption of the Offshore Service Delivery Model by Technology and Artificial Intelligence

Traditionally, companies that have been seeking to reduce costs have followed an offshoring strategy to take advantage of educated, skilled, low-cost labor in countries such as India. They have either outsourced or set up their own Global Capability Centers (GCCs), often requiring large scale, with several hundred full-time equivalents (FTEs) to be cost-effective. However, with the rapid drive to automation, and especially artificial intelligence (AI), the number of people required in place is being dramatically reduced, making GCCs in low-cost jurisdictions feasible at scales as low as a few tens of employees. This movement is a major disruptor to the offshoring industry but provides opportunities for smaller and mid-size entities needing to drive efficiency and reduce costs.

This paper explores the different ways in which small and mid-size entities can embrace such new opportunities in an innovative and cost-effective manner, including examining and mitigating delivery risk. Alvarez & Marsal works with its clients to help design and implement such operating models, making them at the leading edge, with continuous improvement and effective management.

Evolution of the Operating Model in Global Business Services

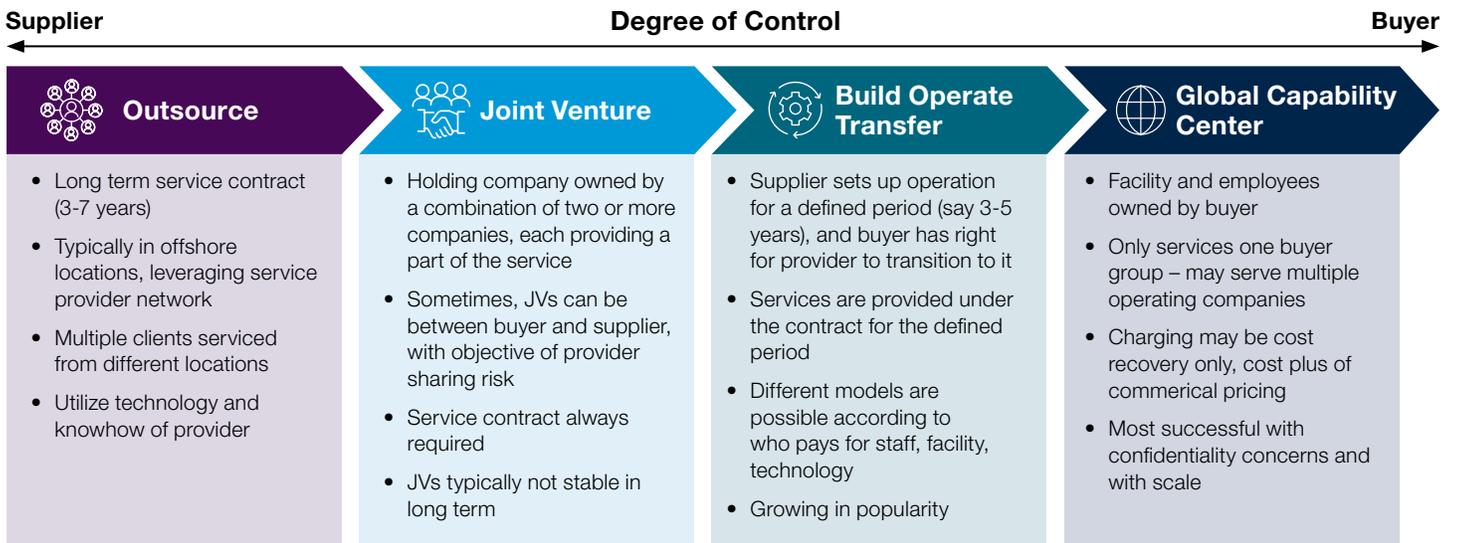
The earliest use of offshoring, from the mid-late 1990s, was typically through captive operations, and especially in financial services, where there is large scale, transactional activity. Early adopters such as American Express, HSBC, BP, GE and British Airways set up captives, as few other options were available. As demand for offshore delivery solidified, outsourcing suppliers began to set up operations, allowing companies with technology and finance requirements at lesser scale to establish low-cost capacity, utilizing the network of a third party, such as IBM or Accenture.

The environment has continued with the dual option of either a GCC or outsourced delivery model over much of the last 20 years, with opportunity growth into areas such as Procurement, Sales Support, Customer Service, Mortgage Processing and Claims Handling, and into geographic regions including Eastern Europe, Philippines, China and Latin America, especially to be able to handle local language requirements. Technology is again challenging the need for multiple centers, as Voice Recognition and Transcription technologies, with chatbots, and progressing into AI, are able to handle multiple languages without the need for physical presence.

There have been situations in which more complex hybrid models have been advantageous to clients. In larger companies, Joint Ventures (JV) have been used, especially in complex service options where one company does not have the complete range of skills required, or in which, an outsourcing supplier is providing capital to support the set up or delivery of services, in return for an ownership stake in a client's operating subsidiary. These situations are not common and are difficult and costly to set up and administer, requiring a Shareholder Agreement, Operating Agreement and a Joint Venture Company board of directors. They are also mainly used for large-scale situations. Alvarez & Marsal will work with clients to advise them of the suitability of such an option.

A second hybrid option, which has become increasingly common in the past five years is known as Build-Operate-Transfer (BOT). In this situation, a company has a desire to establish a GCC operation in a low-cost location. Typically, the company will neither have the local presence nor the knowledge of the local market or brand that enables recruitment; thus, it takes the opportunity to leverage a company with such specialized knowledge and presence to get its GCC established. The partner will typically provide a facility, recruit and train staff, provide a technology environment that allows the business to operate and will offer the company the opportunity to take back the service after a period of operation by the partner, typically in the three- to five-year range. Such an approach has been used by smaller and larger companies, with employee counts ranging from less than 100 to over 2,000.

The spectrum of operating models is illustrated in the chart below.



It is important to note that these examples are points on a spectrum, and the actual models adopted can be variations on these models. Moreover, complex deals are rarely standardized, and are almost always tailor made and bespoke, according to the business situation. Dimensions of variation include, but are not limited to, functional scope of activities, geographies from which service is provided, level of technological sophistication, investment requirements and opportunity for service delivery model improvements.

Global Capability Center ('GCC')

In a GCC situation, the buyer will provide the facility, employ the staff, provide the technology required to deliver the services (both hardware and software) and have the legal structure in the relevant jurisdiction. GCCs require a great detail of detailed care, resource and investment, especially in leadership terms, but have traditionally been effective at larger scale.

GCCs are often culturally more acceptable to clients, especially where the company is working with complex intellectual property, defense export controls or where the company culture is against using third parties. In addition, it is argued that when owning a GCC, the company is not paying a margin to a third-party supplier, and that the cost of the services can be lower, especially when taking a long view.

The advent of new technologies, where more of the work is delivered through automation, drives down the cost of delivering the service, particularly after the initial set up investment is amortized. In addition, with more of the work delivered through automation, GCCs can be much smaller. It is important to note that the migration path to the increased use of technology takes time, and particularly as the technology options themselves evolve. Moreover, the use of these technologies requires that processes are standardized and digitized. This can be a major endeavor, requiring significant time and investment, but it is something that can be adopted and implemented over time. The delivery model is typically a hybrid, between processes that are delivered using a more standard, labor arbitrage approach, and processes that are delivered through technology intensive approaches.

It is complicated to establish and manage a GCC, and special attention is needed to consider the charging basis where three financial recovery methods are possible: cost recovery; cost recovery with a margin; or operations at commercial rates. All are possible but thought needs to be given to the appropriateness of each model, local taxation requirements for profitability in the jurisdiction and availability of new capital to develop and implement improved technologies. There are examples in which innovation has not happened in captives, and service has not been maintained at 'best in class' levels.

In addition, charging models are evolving with the introduction of technology from simple, 'input' based models, relying on hours committed, to 'output' models, based on transactions processes, and progressively to 'outcome' models, where the charge is related to the benefit created.

Outsource

Many companies have looked to outsource select activities over time, most commonly to gain cost advantage, typically driven by labor arbitrage. Outsourcing is generally more straightforward, especially where the services being sought are in a more mature market area, and there is a ready network of potential suppliers. Outsourcing can be done at smaller scale and may be a good option for a mid-size company.

The underlying model entails delivery of services from a supplier's facilities, typically in an offshore location, using their staff and tools, with payment usually on an FTE basis.

A good contract will define the services in detail through Statements of Work and Service Levels, and contracts are, for the most part, in the three- to seven-year time period, dependent on the overall complexity and degree of change required.

Outsourced service delivery is relatively straightforward in concept, and is a mature, proven model. The delivery responsibility rests with the provider, the provider has facilities in multiple locations, trained staff, a recognized brand through which to attract talent, well developed training materials, strong methodologies, software tools and licenses, all with the experience of providing services across multiple clients. The pricing and contractual terms are set against reliable benchmarks, which have been built up over several years.

The model works well with standardized, mature services, if the client effectively manages the contract, and has suitable incentives built in to drive ongoing performance improvement. Regular and robust reporting is required, including ongoing meetings between the client and provider, at which actions and necessary remediations are agreed. Equally as important in today's world of rapidly changing technology, given the move to automation and AI, is a critical need to have a supplier with the ability and incentive to constantly innovate. This can be done with more complex pricing models, especially involving shared risk and reward.

While standard outsourcing is appropriate for mature and well-defined services, and particularly at moderate scale, there are situations where any individual provider may not have the full breadth of skills required, where the buyer requires more control over the delivery elements for reasons of confidentiality or security or where the buyer's ultimate aim is to have its own operations in a lower cost, labor market. In such cases, it may be appropriate to consider an alternative operating model as part of the client's Global Business Services strategy. Options are discussed in the remainder of this paper.

Joint Ventures

Joint ventures have often been discussed, especially as buyers see this as a way in which a supplier buys into their situation and takes some element of risk. In the case of a Joint Venture, two or more parties invest capital or resources in a company, which provides services to the buyer.

There are two broad situations:

- A supplier may invest capital in an operation that provides services to the buyer to demonstrate that they will provide better service from being 'at risk'
- In some situations, where the supplier does not have all the skills required, i.e., typically technology specializations, two or more companies can come together to form a joint venture

Joint ventures are superficially attractive to customers in a number of ways, and may offer benefits, at least in the short term. They are complicated arrangements and pose a number of questions or challenges that need to be addressed. Examples of these questions include:

- ✓ *What funding is required for the Joint Venture entity?*
- ✓ *What is the percentage ownership of each party? How might these change over time, as more capital may be required? How is the input of assets, including technology or other intellectual property, valued?*
- ✓ *What is the board composition and what are the leadership roles, and how many voting seats does each party have?*
- ✓ *What is the relationship between the Joint Venture ownership and the delivery obligations specified in the Service Contract?*
- ✓ *What is the ownership of any intellectual property and usage rights beyond the life of the Joint Venture?*
- ✓ *What are the exit provisions/restrictions?*

There are many more questions that need to be resolved and documented in a Shareholder Agreement.

It is crucial to realize that a Joint Venture Shareholder Agreement is necessary, but not sufficient, in this situation. The Shareholder Agreement documents ownership rights and responsibilities, as discussed above, but it does not set out the delivery obligations, which are contained in separate Service Delivery Contracts. There is no substitute for getting this set up correctly.

Build-Operate-Transfer (BOT)

Some companies have an objective to establish a GCC operation, typically in a lower cost area, but do not have the experience of the business environment in the country in which they seek to establish an operation, nor a brand that can be leveraged to attract and hire talent. Establishing a GCC is typically a long process, especially in a 'greenfield' situation, where the company has no existing presence and needs to set up and staff a facility. Extensive research and due diligence are required in choosing a location, with attention required to factors including availability of trained personnel, access to the facility (local transportation and international airline access), cost relativity and tax and local incentive availability. Typically, it can take 12-18 months to establish a greenfield GCC.

An alternative approach, which has been gaining ground over the past five years or so, is a Built-Operate-Transfer (BOT) construct. The objective of this is to establish a GCC over a period of time but utilizing the infrastructure and expertise of an established supplier. In this scenario, a supplier will agree to establish the operation, utilizing its facility and staff, run the service for a period, which is generally in the three- to five-year period, and then offer the buyer the opportunity to transfer the service (including the staff) from the supplier on pre-agreed terms and conditions.

Build-Operate-Transfer constructs are highly bespoke, and each one is constructed to align with the buyer's requirements. It is critical to work with the customer to establish its vision for the operation, including questions such as what services will be provided, how many people will be required, where will the services be delivered, who will employ the staff, what technology will be used and who will own it and so on. These are complicated questions, and there may not be definitive answers to some of the questions, at least initially. The process of identifying these answers will be done over time, perhaps working with competing suppliers, who can provide different perspectives and options.

The legal framework for a BOT arrangement has two key agreements—a service delivery contract and an agreement defining the relative inputs to the BOT, the governance roles of the customer and the provider and the transition mechanisms from the supplier to the buyer on transfer.

Generally, the supplier will use its facility and hire the staff required; however, this is not always the case. In some situations, the staff will be recruited by the supplier, but the employment will be using a company of the buyer that is established locally for that purpose. Similarly, the tools that are used during the 'operate' period, are typically supplied by the supplier, but there needs to be a provision for a perpetual license to use these tools, post transfer back, normally on a royalty-free basis, including upgrades.

The transfer back can be complicated and requires attention to a number of areas including the facility, the employees and the technology. Assuming that the buyer does not own the delivery facility, it will either need to procure its own facility (typically on a lease) or lease back space from the supplier, which is probably sub-optimal in the longer term. Assuming that the staff were not employed by the buyer and seconded to the supplier, the mechanism for transfer of the staff is a back-to-back termination by the supplier and re-hiring by the buyer on a broadly equivalent basis.

The buyer will need to have formed a locally domiciled company, which owns the assets, employs the people and manages the technology. The charge back mechanisms to the user will need to be considered in detail, and any tax consequences identified carefully. A board of directors will be required to manage the company.

As the operation stabilizes as a company-owned operation, it will be important for the reputation and brand to be established in the local market to facilitate recruitment. Local management will be required, and a focus required on working with users to ensure that services are in line with expectations.

Alvarez & Marsal helps its clients to determine an operating model that is most suitable for its clients. This is done through a series of structured interviews and workshops, whereby the client's situation and objectives are discussed and shaped, potential operating model assumptions and constructs are hypothesized and evaluated to determine which construct might be most suitable. The benefits and risks of the option are rigorously addressed and documented, including both quantitative and qualitative factors and risk mitigation strategies, together with creating detailed implementation plans.

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With over 9,000 people providing services across six continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, leverage A&M's restructuring heritage to help companies act decisively, catapult growth and accelerate results. We are experienced operators, world-class consultants, former regulators and industry authorities with a shared commitment to telling clients what's really needed for turning change into a strategic business asset, managing risk and unlocking value at every stage of growth.

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