Benefits of a long-distance relationship

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The trend towards offshoring – where companies move some of their business operations to other countries – continues to gather pace. Where the shift was once confined to manufacturing activities, today product design and even elements of customer relationship management are taken abroad.

Unfortunately, most companies miss out on the benefits of offshoring because they view it as an opportunity to lower costs in the short term rather than as a long-term strategic decision. Such a narrow view can lead to operational problems and even threaten the viability of the enterprise itself. A broader view can help the company build a powerful strategic advantage. The term offshoring is often used loosely. In this article, it refers to the decision to move business operations to other countries for reasons other than market access. Companies moving operations offshore can either perform them in facilities they own or outsource them to third party providers – but outsourcing is a separate choice.

The siren call

Offshore locations such as China and India provide workers at significantly lower wages than in the US or western Europe. Depending on the skill category and location, the differential may be as much as a quarter to a tenth of prevailing wages in more developed economies. For companies under increasing pressure to deliver short-term cost savings, the opportunity is very seductive. Many have fallen prey to its siren call.

Yet a vicious cycle takes hold when companies focus too narrowly on labour cost savings. They often find themselves unable to hold on to skilled employees, who are vulnerable to offers from companies willing to pay higher wages for the necessary skills. Employee turn over spirals and performance levels drop. Unable to offer superior performance, these offshore operations seek to cut costs even further. Training budgets get cut, relatively inexperienced managers spend even less time on coaching and skill-building and another wave of departures drives performance down again.

Each round of cost cutting provokes another drop in performance, leading in turn to another round of cost cutting. This is a bleak outcome, but it does not have to be this way. In fact, there is much to be gained from offshoring, but we must view it from an entirely different perspective.

A dynamic economy

More sophisticated companies use offshoring to gain access to distinctive skills as well as cost savings. As the chief executive of one leading US company active in offshoring remarked, "re gardless of how big the cost savings are, we would never move to an offshore location unless we are convinced that the offshore location will exceed the operational performance levels of our existing facilities".

In fact, western companies are finding that offshoring locations such as China and India offer access to world-class skills. For example, Jim Breyer, managing partner of Accel Partners, a Silicon Valley venture capitalist, observed: "Taiwan and China have some of the world's best designers of wireless chips and wireless software." In certain types of precision manufacturing, including the processes that produce magnesium alloy casing for notebook computers, companies such as Waffer in Taiwan offer some of the most sophisticated technology in the world.

Most of the leading Indian IT outsourcing companies operate at level 5 – the highest level of expertise – of the Capability Maturity Model (CMM), an international measure of technical skill, while most internal IT departments in western companies operate at level 2 or 3. Call centres, such as those operated by eTelecare – a Manila-based outsourcing provider – offer better average handling times and customer satisfaction relative to leading companies in the US.

However, making decisions about offshoring based on skill levels can be risky, particularly as such levels are subject to rapid change. It is dangerous, too, to look simply at countries such as China and India as a whole – they are in fact an aggregation of diverse regional and local economies growing at different rates and on different trajectories.

The growing specialisation of certain urban areas is one of the key factors driving the rapid skill building occurring in offshore locations. For example, Bangalore has become a centre of application software development, Chongqing is home to highly specialised motorcycle manufacturing and Panyu has become a global centre for diamond polishing.

Some regions are pulling ahead of others in building specialised capabilities and, within those regions, some companies are investing more heavily than others. Western executives should be wary of taking decisions based on a snapshot of skills. They may choose to locate operations in areas that are unable to keep up with more rapid growth in other areas.

If they choose to set up their own operations rather than build relationships with specialised outsourcers, they will need to have aggressive plans to build their own skills base so that they can keep up with investments made by others.

Offshoring as skill building

Rather than merely seeking to access distinctive skills, western companies will benefit a lot more from offshoring if they view it as a powerful opportunity to participate in relationships and environments that can build capabilities more rapidly than would be possible elsewhere. From this perspective, offshoring relationships change from relatively narrow and short-term transactions to enduring and evolving relationships designed to help both parties get better, faster. What is the nature of this opportunity? There are three main aspects.

Different management techniques. First, the lower wage rates of enterprises in offshore locations allow them to deploy management techniques that are difficult, if not impossible, to reproduce in developed economies. For example, a company such as eTelecare employs roughly one manager for every eight call-centre workers, versus one for every 20 or more in western call centres. This makes it easier to coach staff and identify places where processes can be improved. Engineering companies in Taiwan often deploy teams in parallel to develop alternative designs of products.

Specialised ecosystems. Local networks of specialised businesses, or ecosystems, provide a rich infrastructure of complementary services (legal advice, accounting, marketing and so on) and opportunities through informal networks and competitive recruiting to learn from other companies. Ecosystems have driven the rapid growth of skill bases in cities as diverse as Bangalore and Chongqing.

Process networks. Finally, "global process networks" help connect far-flung companies. These represent a new way of managing such core business processes as supply chain management and product development spanning hundreds, if not thousands, of highly specialised business partners. Rather than tightly integrated operations managed in a top-down fashion, these networks rely much more on modular management techniques to provide greater flexibility and enhance the potential for innovation. Chinese companies pioneered many of these networks in industries as diverse as clothing, motorcycles and consumer electronics.

For example, when a western company contracts with an original design manufacturer in Taiwan, such as Compal, it is gaining access not only to Compal's capabilities but also to its well-developed process network for the design of a new computer notebook. The network connects specialised companies in Taiwan's ecosystem, but also reaches out to companies in other ecosystems including Korea, Singapore and Malaysia.

This broader approach to offshoring has its own risks. Western companies need to decide what distinctive capabilities they require and then master techniques needed to get better, faster. If they stumble, other more aggressive companies may squeeze them out.

Even greater, though, is the risk of not attempting it. Western companies that see operations abroad solely as a cost-cutting exercise will be unable to take advantage of the skill-building opportunities they offer. They will be caught in their own vicious cycle – cutting costs in an effort to cope with squeezed margins, fighting deteriorating performance and then forced to go through another round of cost cutting.

Offshoring provides an opportunity to harness the dynamic growth occurring in countries such as China and India while helping western companies to get better, faster. Standing on the sidelines represents the highest risk of all.

Moving offshore

- Companies that use offshoring solely to cut labour costs often face a backlash: the narrow focus on costs can lead to high staff turnover, cuts in the training budget and declining performance.
- Markets such as India and China offer world-class skills in fields such as technology, call-centre management and precision manufacturing.
- Sophisticated companies get much more from offshoring if they exploit the intricate business networks of popular locations such as Taiwan, Chongqing and Bangalore.

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