The Future of Knowledge Process Outsourcing
Make or Buy in KPO?
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Executive Summary

Since the late ’90s, the Knowledge Process Outsourcing (KPO) industry has seen strong growth and a variety of models emerging. However, as the industry begins to mature, many are curious how KPO will evolve over the next five to ten years. Evalueserve, a global research and analytics firm based in Gurgaon, India, covers the KPO industry and regularly publishes perspectives on trends and key issues affecting the industry.

This white paper focuses on three key issues:

- What is the fundamental business model the industry is driving towards?
- Which engagement model will prevail – Make or Buy?
- Where will long-term growth come from?

Evalueserve conducted an in-depth research, analysing trends and economics, yielding interesting, and in certain areas, surprising results. These results are revealed below and supported by external experts, consulting firms and senior planners in offshoring strategy departments of companies running self-owned (‘captive’) KPO operations.

While there are clearly some important differences between the recent KPO phenomena and traditional IT outsourcing, the fundamentals of the evolution of these offshoring models are very similar. Evalueserve has identified four phases valid for both industries: 1) Arrival of Western captives II) Rise of Indian vendors III) Expansion of Indian vendors and IV) Indian vendors surpassing captives. KPO is highly likely to follow the now mature Offshore IT Services model with a 10-year time shift. This implies that ‘Buy’ will be the standard engagement model in 2010, while clearly successful captives that cross the critical-mass size of about 300-500 professionals will continue to exist and grow. However, captive units below 300-500 professionals will struggle with significant issues in terms of cost, attrition or effectiveness.

Important differences between KPO and IT will lead to interesting deviations from the IT model. The average engagement size in KPO is much smaller, which requires a fundamentally different model in sales force compensation and workflow management, but at the same time, allows KPO vendors to market their services to Small and Medium Size Enterprises (SMEs) in a highly effective manner. Due to the large number of addressable SMEs (several hundred thousand companies), the growth potential for the KPO industry is highly substantial. Managing this complexity and making the model scalable will be the main differentiators in the vendor market.

A detailed qualitative and quantitative comparison of captives below critical mass and vendors capable of delivering the required services shows very clear advantages of the ‘Buy’ model – in terms of lower cost and complexity as well as higher speed, flexibility and effectiveness. In fact, a financial analysis of a captive of 40 professionals compared to a vendor engagement shows a cost difference of up to 30% in favour of the ‘Buy’ model during the first five years of operation, mainly driven by much higher upfront costs and insufficient economies of scale later on. Evalueserve has identified three phases in setting up offshore KPO units in the ‘Make’ model: I) Set-up phase II) Honeymoon period and III) Stagnation period. Vendors are much faster in setting up centres for clients and stabilising the quality of operations: Clients can save up to 12 months in time-to-market. Moreover, clients do not incur any
upfront capital expenditure and have much lower levels of international overheads (e.g., trips including expenses and opportunity costs, expat compensation packages). During the honeymoon period, captives can do well in terms of providing growth opportunities for their employees, although economies of scale and scope are clearly much less developed than those for vendors. During the stagnation phase, people motivation and cost escalation become major issues due to increasing staff tenure. These factors are likely to drive a majority of companies considering KPO towards the ‘Buy’ model in the years to come. Interestingly, some companies with captives that were set up between 2000 and 2004 have also begun to leverage vendors for complementary skills, peak-load absorption, and cost and quality benchmarking, or are even thinking about spinning off their captives. Naturally, there will also always be companies opting for the captive model due to special circumstances, such as regulatory requirements, protection of trade secrets, etc.

A quantitative forecast by Evalueserve modelling these trends predicts two major changes in the KPO industry. Firstly, capacity addition by vendors is likely to surpass additions by captives by 2010. Secondly, the SME customer segment will become the most important long-term growth driver for KPO vendors, both in terms of number of professionals and number of companies. Evalueserve predicts an overall growth from 75,000 KPO professionals in 2006 to about 250,000-280,000 professionals (depending on the scenario) by the end of 2010, a market size of USD 11 billion to USD 12 billion and a rise in the number of mostly western companies leveraging KPO as customers from about 900 to over 5,000 largely driven by SMEs. This is still a small number compared to the several hundred thousand SMEs that are addressable by KPO services. Evalueserve also expects that by 2010, vendors will add about 55% of new KPO capacity as opposed to 45% for captives, and more than 80% of all KPO set-ups will use the vendor model. The future of KPO seems bright; however, for this to happen, vendors will need to globalise and develop scalable processes to serve large and diverse companies.

KPO to follow IT model – with a 10-year time shift

Evolution of ‘Make vs. Buy’ in IT Offshoring – preparing the road for KPO

Offshoring of services to India by western companies started with the outsourcing of IT services during the late ‘80s. It began with the setting up of self-owned centres or ‘captives’ by large IT companies (such as IBM, Texas Instruments, Motorola and HP) as there were only a few, very small third-party service providers at that time. Western companies also wanted full control to ensure that the quality of services and information security norms were in accordance with their Western standards. There was seemingly no question of ‘Make vs Buy’ and the large companies had to rely on the captive model.
The rapid growth of the Indian IT industry that followed these early efforts can be divided into four phases as detailed below.

**Phase I – Arrival of Western Captives (1985-1991)**

Though the benefits of offshore outsourcing were always evident, it was difficult for western companies to enter India before 1984 due to unfavourable government policies, for e.g., the Foreign Exchange Regulation Act (FERA) and heavy import duties. In this phase, western companies began to set up their captives in India that led to the development of an embryonic offshore IT industry. The primary drivers for these companies for setting up captives were as follows:

- Developments in networked computing that led to a shift from mainframe to networked systems and allowed easy data transfer
- Reduction or elimination of import duties on hardware
- Establishment of STPIs (Software Technology Parks of India), which provided a variety of benefits to companies registering under this Indian government plan
- Cost differential, both in salaries and infrastructure costs

Texas Instruments was one of the first firms to set up its captive in India with the intention of writing software for product development. Other firms, such as COSL, Motorola, HP, ANZ and Citigroup, followed. In all, 24 western companies established captives in India during this phase.

Telecommunications represented a significant challenge at the time and it was only in 1989 that 64-kbps satellite links became available through the government’s telecom operator, VSNL. This advancement provided a completely new way of functioning to the software exporters, where initially software export meant the physical transfer of either programmers or software floppy discs. Another significant development during this phase was the formation of representative trade associations (one of which eventually became NASSCOM).

During this phase, a series of young and relatively small IT services vendors emerged. The total number of software companies in India increased from 35 in 1984 to 700 in 1990.


The liberalisation of the Indian economy in 1991 and later in 1995-96 resulted in a steady flux of western companies to India. Eighty captives, some fairly large, were established during this phase. However, Indian vendors flourished as well with the total number reaching 250. The drivers of this growth were the liberalisation of the Indian economy and the new opportunities created by the Y2K problem. Other developments included

- The government’s STPI plan, which provided access to cost-effective infrastructure, and thereby, facilitated industry growth
- Indian firms’ establishment of dedicated Offshore Development Centres (ODCs) providing services to companies worldwide
- Indian companies working on multiple client engagements
• Emergence of the SEI-CMM quality certification – more than half of SEI-CMM 4 and 5 rank companies were Indian by the end of 1998
• The listing of Infosys on the NASDAQ stock exchange in 1999

By the end of 1999, the Indian IT industry was at an all-time high and Initial Public Offerings (IPOs) of Indian software companies (in India) were oversubscribed. This, in turn, led to the birth of the venture capital industry in India. According to figures released by the Indian Venture Capital Association, VC investments exploded from USD 24 million in FY 1996 to USD 480 million in FY 1999.

In the late '90s, western companies had ample choices for selecting offshore IT vendors and no longer depended on the captive approach, which shifted significant market share away from the captive to the vendor model.


The tremendous growth in the offshoring space led players to exploit opportunities and expand, both in terms of value-added services and the geography they catered to.

• An increasing number of Indian IT companies went global by providing services to major companies worldwide and opening additional delivery centres outside India
• Indian IT companies moved up the value chain by providing services in emerging areas, such as packaged software implementation, systems integration, network infrastructure management, IT consulting and service-oriented architecture.
• The industry matured, both in terms of service standards and client interaction models. The emphasis on data security and meeting world-class quality standards in services became critical in this phase. As of December 2005, over 400 Indian companies had acquired quality certifications with 82 companies certified at SEI CMM Level 5. In addition, Indian companies entered into more advanced types of contracts with clients. This included maintaining Service Level Agreements, Non-disclosure Agreements, Non-tampering clauses, etc. Moreover, country laws, such as the IT Act 2000, the Indian Copyright Act, the Indian Penal Code Act and the Indian Contract Act 1972, were able to safeguard companies entering the offshoring space.

Phase IV – Indian IT vendors surpassing captives (2004 to present)

The increasing maturity of the industry and the specialisation of vendors eventually led to a clear advantage for vendors (Indian vendors or also western vendors with centres in India, such as Accenture, IBM, etc.) over captives of non-vendor companies, further accelerating the shift away from captives. Western companies realised they could reduce complexity costs by working with professional vendors. This also allowed their firms to focus on running their businesses rather than coping with the intricacies of setting up and running captives of size less than critical mass. Clearly, there are some western vendors (e.g., Accenture) with captives in India.

The share of Indian vendors in Indian IT offshore services has increased rapidly. As per NASSCOM, the global market share of Indian vendors today amounts to more than 60%.
KPO to follow IT Model

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. Figure 1 compares the evolution paths of these two industries. There are even some indications that the KPO industry is developing more quickly than the IT industry did 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, neutralising the effect to some extent.

Figure 1: KPO following the IT model with a 10-year time shift
It is evident from Figure 1 that KPO is consistently following the offshore model of the IT industry, however, with a time shift of about 10 years. The analogies between the IT industry and the KPO industry for the four phases are provided below.

**Phase I – Entry of western companies in India (1997-1999)**

The offshoring of KPO services began with the arrival of western companies in the late '90s. Initially, there was no question of ‘Make vs Buy’, as there were no KPO vendors. GE and McKinsey pioneered the offshoring of KPO services, as they had enough capacity to set up their captives in India. The critical mass threshold for a captive at that time was around 100+ employees, which effectively excluded SMEs from accessing affordable and flexible offshore solutions since there were no independent vendors at the time.


While western companies were still setting up captives in India, two new types of KPO players emerged: KPO vendors focussing on KPO only (‘pure-play’) and most often on a single area within KPO, and BPOs adding certain KPO activities to their BPO service portfolio. Table 1 provides examples of leading companies in each category, while there are certainly many more. Some estimates are as high as 400 players, although most of these are very small companies.

<table>
<thead>
<tr>
<th>KPO Captives</th>
<th>Focussed KPO Vendors</th>
<th>‘BPO adding KPO’ Vendors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goldman Sachs</td>
<td>Evalueserve (Research + Legal)</td>
<td>Progeon (Research)</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>Amba Research (Research)</td>
<td>Genpact (Analytics + other)</td>
</tr>
<tr>
<td>JP Morgan</td>
<td>Irevna (Research)</td>
<td>WNS (Research)</td>
</tr>
<tr>
<td>UBS (2006)</td>
<td>Copal Partners (Research)</td>
<td>OfficeTiger (Research)</td>
</tr>
<tr>
<td>Credit Suisse (2006)</td>
<td>Inductis (Consulting/Research)</td>
<td>Wipro (Consulting)</td>
</tr>
<tr>
<td>Deutsche Bank (2006)</td>
<td>Aranca (Research)</td>
<td>Accenture (Research)</td>
</tr>
<tr>
<td>SAP (Product Development)</td>
<td>marketRx (Research)</td>
<td>Integreon (Research)</td>
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<tr>
<td>GE (Technology Research)</td>
<td>Netscribes (Research)</td>
<td>Mphasis (Research)</td>
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<tr>
<td>Microsoft (Product Development)</td>
<td>RocSearch (Research)</td>
<td>Nipuna (Analytics)</td>
</tr>
<tr>
<td>IBM (Technology Research)</td>
<td>Scope e-Knowledge (Research)</td>
<td></td>
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<tr>
<td>Others</td>
<td></td>
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</tbody>
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Table 1: Examples of KPO players
The emergence of KPO vendors suddenly offered an alternative to the captive model. Large companies now had the choice of setting up captives or working with one or several vendors, or both. Also, for the first time, western SMEs now had the possibility of leveraging the offshore potential by working with vendors who were capable of handling their usually smaller-volume requirements (see Figure 2).

**Figure 2: Trends in KPO Offshoring Model – KPO Vendors providing offshoring opportunities to SMEs**

<table>
<thead>
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<th>KPO Captives</th>
<th>Focussed KPO Vendors</th>
<th>‘BPO adding KPO’ Vendors</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P/Capital IQ (Research)</td>
<td>Patent Metrix (Legal)</td>
<td></td>
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<tr>
<td>Intellevate (Legal)</td>
<td>Lexadigm (Legal)</td>
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<tr>
<td>GSK (Pharma)</td>
<td>Biocon (Pharma)</td>
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<tr>
<td>Pfizer (Pharma)</td>
<td>DRL (Pharma)</td>
<td></td>
</tr>
<tr>
<td>Eli Lilly (Pharma)</td>
<td>Ranbaxy (Pharma)</td>
<td></td>
</tr>
<tr>
<td>Thomson Digital (Publishing)</td>
<td>Others in many other areas</td>
<td></td>
</tr>
<tr>
<td>KnowledgeWorks Global (Publishing)</td>
<td>(Engineering &amp; Design, R&amp;D, etc.)</td>
<td></td>
</tr>
<tr>
<td>Techbooks (Publishing)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others in many other areas</td>
<td></td>
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</tbody>
</table>

No offshoring avenues for SMEs present in the market

KPO vendors providing offshoring opportunities to SMEs

Providing services to both SMEs and large companies

Not cost-effective

KPO vendors have been expanding their operations supported by the strong overall growth in the KPO sector. Driven by the global nature of their clients’ work, vendors are starting to internationalise their operating platforms and sales forces. For example, a specialised vendor, Amba Research, opened a Latin American Operations Center in Costa Rica in 2006. Evalueserve opened operations centres in Shanghai, China, in 2005 and Santiago, Chile, in 2006, following the model of IT services firms such as TCS, and large BPOs such as Genpact. It is just a matter of time before specialised players also open operations centres in Eastern Europe, probably in 2007 or 2008. Additionally, some focussed KPOs have mastered the challenge of scalability by creating international sales forces, setting up sales offices in the Americas, Europe and Asia, and by building scalable recruiting practices and operation systems, and disciplined processes to handle the increasing complexity of KPO work.

Again, driven by client demand and enabled by economies of scale and scope, KPO vendors are also moving up the value chain in a variety of areas. Specialisation is leading to increasingly deeper knowledge in certain areas, allowing vendors to perform work that would have been impossible even two to three years earlier. In some cases, this specialisation has allowed vendors to become more effective and productive than their clients’ own operations. Moreover, clients feel increasingly comfortable outsourcing new types of work, as vendors keep investing in new skills enabling new types of services. Some examples include intellectual property portfolio analytics or the white-labelling of new database products.

As in the case of the IT industry, the security practices of KPO vendors have also matured and are accredited with rigorous ISO certifications such as ISO 27001. Physical, legal and information security measures have become critically important; contractual agreements, such as Service Level Agreements (SLAs), non-disclosure agreements, non-tampering clauses and contingency planning, are becoming standard components of contracts, thereby improving credibility and reducing the resistance to offshoring.

Similar to the evolution of IT and BPO firms, the critical mass for KPO organisations keeps increasing. While the minimum ideal size of IT and BPO operations has surpassed 1,000 people, KPO operations currently have a critical mass of about 300 employees and this threshold is likely to reach 500 before 2009. Below this level, KPO operations have high overheads and a lack of brand recognition, both in the recruiting market and with clients.

Phase IV – Vendors surpassing Captives (2010 onwards)

With increasing specialisation and scale, KPO vendors are likely to capture a larger share of the KPO market. Large western companies that have not yet set up captives are likely to choose vendors due to reduced complexity, shorter time-to-market, higher flexibility and lower overall cost. Even large western companies with existing captives are beginning to work with vendors for complementary tasks that their captives cannot execute. Finally, with engagement sizes being much smaller (usually 2-10 Full Time Equivalents per SME as opposed to several hundred employees in the case of BPOs/IT services), SMEs looking for KPO support are unlikely to have enough KPO work to reach the critical mass of 500 employees and are, therefore, highly likely to choose the vendor model. In fact, SMEs will be one of the key growth drivers for the KPO industry in the years to come. Estimates show that out of...
about 10 million SMEs in the US and Europe, up to about 5-10% (0.5-1.0 million) SMEs could benefit from KPO in one way or the other.

**Differences between IT and KPO**

In spite of all these similarities, some important differences between IT/BPO and KPO will affect the long-term direction of the industry:

- Due to a much smaller average engagement size (two to ten FTEs or even project sizes of USD 1,000 and less), the complexity of KPOs is much higher and requires very different processes in operations and sales. KPOs need to be run as ‘professional services’ firms requiring a different type of talent and not as white-collar factories.

- For certain KPO services, R&D or services with special regulatory requirements, companies might never go down the vendor route because these services are so core to the company’s business. In India alone, we can count more than 150 R&D captives, where companies were not willing to outsource core parts of R&D to vendors.

- As the most important driver of scalability, an international sales force must have completely different commission systems. Commissions must be much higher (5+% of revenue) and recurring in nature, rather than just one-off ‘deal-volume-based’ commissions of 1-2% as in the IT or BPO industry. Consequently, the number of account executives per million USD of business is much larger, too.

- Scalability will remain an issue for many KPO firms due to the added complexity and the challenge of setting up scalable sales forces.

- The critical mass of a KPO operation is about two to three times smaller than in IT/BPO operations, i.e., 300 vs 1,000 in 2007 and 500 vs 1,500 in 2009.

- The size of the IT industry is almost 10 times the KPO market size and the number of professionals employed is 15 times higher. At the end of 2006, more than 1.1 million of FTEs were working with the Indian IT offshore industry, generating revenue of USD 22.3 billion. However, the total number of FTEs working in the KPO industry in India was approximately 75,000 and it generated revenue of USD 3 billion. Evaluserve estimates that this number will increase to about 250,000-280,000 by 2010, depending on the scenario, with revenues of USD 11 billion to USD 12 billion in India.

- While the average engagement size is small, the addressable market in terms of number of clients is very large. On the other hand, BPO and IT companies continue to focus much more on large corporates.

Overall, IT and BPO have certainly paved the way for KPO. However, the scalability challenges in KPO will prevent KPOs from significantly reducing the time lag of about ten years. In fact, many KPO vendors will look to be acquired by larger competitors or foreign companies before issuing IPOs, as demonstrated by the recent acquisition of the 200-person Marketics Technologies by WNS for a very high valuation of a reported USD 30 million in cash and USD 35 million in earn-outs at an estimated revenue multiple of 8 to 9.
Shift towards Vendor Model and Growth from SMEs

In IT, the vendor model surpassed the captive model because the value proposition of Indian IT vendors became more attractive than that of captives. Higher degree of specialisation, lower overall cost, greater flexibility, faster set-up and improved credibility made the vendor model the standard route to follow. These same advantages will benefit the vendor model in KPO and drive its growth. This is not to say that captives cannot be successful. There are several examples of highly successful KPO captives that have reached critical mass in KPO, such as GE’s Jack Welch Research Center and SwissRe’s captive centre. However, there will be few companies large enough to set up captives that can attain critical mass. For most other companies, the vendor model provides a superior value proposition.

Comparison of KPO Vendor Model and Captive Model

Reduced Management Complexity, Speed and Flexibility

Offshoring to vendors reduces management complexity and lets western companies focus on their core operations. Although companies set up captives hoping for the same benefits, they later realise that considerable senior management time is required during both the initial stage and the steady state. Moreover, setting up centres with vendors saves time and provides much greater flexibility.

- Faster initial set-up
  - **KPO Vendors:** Buying services from KPO vendors does not involve any upfront effort as the western firm can always choose focussed KPO vendors with well-established processes and expertise. With a number of KPO vendors in the KPO industry today, there are choices in the market. After vendor selection, western companies can focus on managing the vendor as per pre-agreed SLAs and engagement terms, which requires some effort, but much less than a captive. Vendors can deliver stabilised services after about three to six weeks. In fact, vendors can ramp up their teams faster, but this is typically slowed down by the end client’s internal decision-making processes.
  - **Captives:** A captive set-up involves site selection, legal clearances and locating office space. It also typically requires four to six months of significant management involvement that, if not provided, is likely to slow down the ramp-up and transitioning of processes. After these initial four to six months, stabilising the operations in terms of hiring and output take a significant amount of time. Figure 3 compares setting up a 40 FTE research centre in vendor mode versus captive mode.

- Faster and easier initial staffing
  - **KPO Vendors:** Vendors usually have trained professionals on board, even before a new engagement is kicked off. This allows them to staff new projects with the right skills within days or weeks rather than months. Moreover, given their size, vendors have a much higher likelihood of being able to staff the required skill profiles right away.
Captives: Captives need to hire teams from the open market. This inevitably means hiring experienced people from other companies, which forces them to pay a premium of about 30-50%, especially when the captive does not have much brand recognition in the labour market. Significant fees for search firms can figure into costs as well. All of this takes several months and absorbs significant western management attention.

Better long-term employee retention

KPO Vendors: Most well-run vendors with sizes above the critical mass (>300-500 FTE) are experiencing robust long-term growth. This enables them to offer their employees more senior roles and career opportunities. This is absolutely critical, especially in KPO, where the share of highly educated and very ambitious professionals is very high.

Captives: Most KPO captives are not likely to ever reach critical mass in KPO processes (Synergies with any existing BPO units are very limited). After an initial phase of intense growth (the ‘honeymoon period’ during the first 24 months), captives tend to stagnate in size. At that point, they are typically not able to provide enough career opportunities to employees, which causes attrition. Senior management needs to constantly work on motivating and retaining employees, by taking measures, such as providing onsite visits/training and offering higher-than-market compensation. Of course, all of these measures add significant cost overhead.

More flexibility

KPO Vendors: Companies that choose the vendor model typically benefit from a high degree of flexibility. They can ramp up or down with notice periods of between one and six months. Additionally, they can work with various vendors, benchmarking them against each other or using them for processes where the respective vendors have the best skills. Some companies are starting to use vendors in addition to their own captives, predominantly for complementary capabilities. For example, a top-10 bank has its captive in India, but also leverages Evalueserve’s operations hubs in Chile and China for its Market Research capabilities and for some Investment Research projects. Other companies are using vendors simply to put their own captive under pressure in terms of skills and costs.

Captives: Captives offer much less flexibility since employees are on their payroll. Interestingly, there is the additional effect of vested interests. Some decision-makers, who made the initial decisions to set up captives, lobby very hard for the captive given their vested interests, which again reduces flexibility. Moreover, many companies artificially distort market forces by adding incentive schemes to divisions to outsource their work to the captive rather than to vendors. In the case of a large Investment Bank, the corporate centre pays for the captive’s infrastructure cost and the line units pay only the variable costs. This leads to hidden costs in the system that, if analysed correctly in a fully loaded way, drives the overall costs well beyond free market costs.
• Better control in many cases
  - **KPO Vendors:** Many western companies believe that control over captives is higher as compared to control over vendors. This may be true in theory, but as our polls suggest, this is hardly ever reflected in reality. Vendors are controlled via arm’s length contracts with SLAs. If a client feels that a vendor’s performance is unsatisfactory in terms of quality and cost, the relationship is at stake and the vendor will work harder to immediately deal with any problems that arise. Therefore, companies have a comparatively higher degree of control over vendors.
  - **Captives:** While companies ‘own’ their captives, they usually exert a much lower degree of control over them than might be believed. A part of the reason is governance. Typically, the captive reports to some central management function such as the CFO. If the line head, i.e., the COO of Equities Research, requires a change within the captive, he or she would have to follow the line of command. Very often, the KPO is embedded in an IT/BPO captive running a very different people model, which reduces the level of control even further. Moreover, in practice, companies treat vendors in a much tougher way than they treat internal units in terms of performance management.

• IT and compliance
  - Clearly, the biggest challenges for the vendor model are issues related to IT and compliance. Captives get full IT access rights and are subject to standard compliance procedures, as they are typically wholly owned subsidiaries. Vendors, on the other hand, usually get ‘as-needed’ IT access and need to be audited using supplier audit procedures, which is why some investment banks create their own captives. However, the successful examples of other investment banks show that these issues can definitely be overcome.

**Figure 3: Building a 40 FTE Research Centre – Vendor vs Captive**
Lower fully loaded costs of operation

Conventional wisdom suggests that operating costs of captives are lower because they do not include the profits that vendors include in their pricing. However, if calculations are made on a fully loaded basis over several years, the higher cost efficiency of vendors more than makes up for any profits that they include in their rates. Sudin Apte, senior analyst and country head, Forrester, India, and even some offshoring strategy departments of companies using the captive approach that were interviewed by Evaluserve, admit that captives would always be more expensive on a fully loaded cost basis. In general, there is evidence that cost sensitivity and control are significantly lower in captives than with vendors that have to go through professional procurement processes. The main effects are as follows:

- During Initial set-up and ‘honeymoon’ period
  - Expenses and opportunity costs of offshore travels by western management can add up to more than the total billing of the captive during the first year. Managing captives entails significant involvement from senior management during and after setting up for proper transitioning of processes and people management. Working with a vendor typically reduces such efforts by 60-70%.
  - Expat salaries and allowances increase operating costs. Most captives require significant number of expats offshore, frequently Non-Resident Indians (NRI) returning to India. Working with vendors eliminates the need and costs for expats.
Lack of scale creates significant overheads in G&A (HR, Finance, IT, Legal, Infrastructure). KPO vendors typically manage a ‘support staff’-to-‘billable professionals ratio’ of 1:8 or even better. A 40 FTE captive is likely to experience a ratio of 1:4-5 at best. This effect alone accounts for an inefficiency of 7.5%. A lack of scale in infrastructure is likely to cause additional inefficiencies of 3-5% in steady state and about 10-15% during start-up phase.

‘Buying’ KPO professionals from the open market at a 30% premium raises overall salary costs. Lower cost sensitivity can also be experienced by anecdotal evidence.

- A consulting firm bought exactly the same EPBX phone system with exactly the same features for more than three times the price a vendor paid.
- In another situation, a captive in Gurgaon spent over 30% more for interiors than a vendor in the same building with the same carpet area.
- A consulting firm’s captive is highly profitable as a ‘quasi business unit’, since an internal transfer-pricing scheme with prices significantly higher than free-market rates, which clearly reduces cost pressures on the captive.
- A bank subsidises its captive by paying for its infrastructure from a central budget not transparent to the business units, which again reduces the cost pressure on the captive AND on the lines of business.

Stagnation

- Salary increases of about 25% per annum caused by the increasing average tenure of staff begin hitting captives during the stagnation phase. On the other hand, vendors can renew their junior staff as more senior professionals move up the ranks, thereby keeping the average tenure constant and keeping increases in hourly costs to about 7% per annum, which corresponds to the annual increase for talent of the SAME tenure. For example, an analyst with two years tenure in 2006 will cost nearly the same as another analyst with two years tenure in 2007.
- The lack of economies of scale still creates very significant overheads in G&A, recruiting and training. In all likelihood, the offshore captive will require more visits by western management than a large KPO with self-sufficient recruiting and training capabilities.

The analysis of a case example of a 40-professional KPO unit yields surprising results when calculations are made on a fully loaded basis. Evalueserve estimates show that for an apples-to-apples research capacity (even before any productivity effects, where the vendor is, in all likelihood, going to be more productive due to learning curve effects), the captive is about 20-30% more expensive than a vendor over a five-year period. A very detailed cost analysis can be demonstrated over the identified three phases:

Phase-1 – Set-up: The captive incurs significant investments of about USD 700,000 up front and has to start with significant international and local overhead. Also, hiring and training takes time; during this period, the professionals are not productive. Clearly, all infrastructure for 50+ employees (40 billable professionals and 10+ support staff) need to be in place from day one. This
leads to very significant costs during Year 1, whereas a vendor can offer fully variable prices that have benefits due to scale benefits and a much-reduced need for international overheads.

- **Phase-2** – Honeymoon: As the captive ramps up, it gains scale and reduces costs per head. But even then captives are likely to be about 10-12% more expensive than vendors. This is the period in which the cost differential is the smallest.

- **Phase-3** – Stagnation: As the employee base gains tenure, costs per employee increase more rapidly than in a vendor centre. The cost gap widens again to about 15-16% in Year 5.

**Figure 4: Costs of stand-alone 40 FTE Research Centre – Fully loaded annual costs**

This analysis is valid for stand-alone KPO units. If a KPO unit is embedded in a much larger BPO captive, surprisingly limited synergies are achieved, predominantly in Infrastructure and Administration, thereby reducing the cost differential to some degree. Most other overheads including International Headquarters, HR, International overheads, etc., are likely to remain at similar levels. Estimates show that operating costs in the first one or two (1+2) years are higher due to office space that needs to be set aside, infrastructure that needs to be established without being fully utilised, western professionals flying in to hire and train professionals, etc. In the Year 3, operating costs almost approach vendor price, whereas in Years 4 and 5, the difference in salary increases starts widening the gap again. Just to re-emphasise: A vendor can provide fully operational services with all processes stabilised and knowledge available after about four weeks, while captives need at least a year to stabilise operations to achieve similar effectiveness and productivity rates.
Economies of scope leading to improved effectiveness and productivity

KPO vendors cater to a wider pool of clients and analysts are exposed to varied types of projects across diverse industry verticals and functional areas. This leads to improved effectiveness and higher productivity.

- **Building Domain Expertise:** A vendor with a total staffing pool of 1,500+ professionals can invest more in the specialisation of skill profiles than a captive with 40 professionals. For example, in investment research, a vendor can add market research, business research and technology research functionalities to the overall service.

- **Building Knowledge Management Processes:** Large-scale vendors have the critical mass for investing in productivity-enhancing workflow systems, e-learning systems and knowledge management activities. Moreover, established vendors are likely to have access to a much wider range of databases.
  - Development of training modules
  - Subscriptions to various databases and paid journals
  - Knowledge sharing based on intranet tools

- **Productivity and Quality Control Processes:** Due to their SLAs, vendors must develop productivity tracking tools (workflow and utilisation reports, variance reports, time sheets, etc.) as well as quality control processes (feedback loops linked to HR performance management processes, etc.). Captives very often do not have these clearly defined SLAs due to their ‘monopoly status’. Productivity tracking translates directly into tangible cost savings. Evalueserve estimates that abiding by SLA parameters can lead to a 10% productivity increase. In the case of a 40 FTE centre, this corresponds to savings equivalent to 4 FTEs (not included in the above cost analysis). Very often, outsourcing to vendors also allows concurrent or sequential re-engineering of processes driven by external best-practice, which seems to be rare in captive environments.

- **Geographical Coverage:** KPO vendors are increasingly developing multi-continental operations hubs. They can now provide multi-lingual KPO services, tap local labour markets (thereby reducing their sensitivity to the Indian labour market) and provide true 24X5/7 support, which is not possible from India alone without significantly increasing attrition. For example, Evalueserve has research centres in India, China and Chile. Amba Research serves their customers out of Sri Lanka, India and Costa Rica. Indian captives cannot provide such a value proposition.

Reduced attrition rates enhancing quality of service

Both vendors and captives are challenged to keep attrition rates as low as possible, especially in ‘hot’ labour markets such as India as confirmed by Sudin Apte, senior analyst and country head, Forrester, India. While best practice captives (e.g., SwissRe, GE Research) are doing well in terms of attrition, several captives are struggling to retain employees during the stagnation phase for the following reasons:

- **Fewer Leadership Opportunities:** In most cases, KPO captives do not have the critical mass of about 300-500 professionals. Just being a part of a much larger BPO/IT services captive does not help, as careers do not cross silos. When captives stagnate, typically after 24-36 months of
operation, fewer leadership opportunities are available. KPO professionals (typically MBAs, PhDs, CFAs, etc.), especially in India, are extremely ambitious and have very high expectations of being promoted quickly. During stagnation, professionals begin to look for external opportunities. High-growth vendors, on the other hand, can offer a multitude of leadership and promotion opportunities to their analysts.

- **Secondary-citizen Syndrome:** Increasingly, it is becoming clear that captives are subject to ‘glass ceilings’, i.e., many employees of captives are treated as so-called ‘secondary citizens’. For example, less than 1% of employees ever make it to the West for on-shore jobs as, for example, Equities Research analysts in NY or London. After 24-36 months, this effect becomes apparent. On the recruiting side, applicants are becoming aware of such effects, which put a discount on the hiring brand equity of captives. Also, many vendors allow their large clients to hire up to 5-10% of the vendor’s staff dedicated to them annually, putting vendors at least on par in terms of sourcing talent for western operations.

**Quality standards at par with international standards**

KPO vendors have matured in terms of meeting international standards. Several leading investment banks have internal offshoring consulting teams working with KPO vendors to provide research support of highest quality standards. In fact, Evalueserve research shows that performance ratings of vendor analysts are at least on par with captives, and in some cases, even higher. This is further supported by research conducted by Wharton professor Ravi Aron, who analysed performance standards of captives and vendors. Further, KPO vendors are taking data security and intellectual property issues very seriously and have begun adopting standards such as ISO 27001, the latest standard for IT security and Information Management (standards that even many western firms do not have).

**Trends in the market place**

Early research by Evalueserve, based on public information, client trends and interviews, and Forrester’s Sudin Apte suggest many companies have become aware of their captives’ limitations in the market place and have started responding differently to these market forces.

- **Spinning off Captives:** General Electric’s private equity spin-off of its BPO captive, creating a vendor called Genpact, provides strong evidence confirming the points made above. Genpact has successfully managed the transition from a captive into a vendor, and in all likelihood, will go public in 2007 with a market capitalisation of beyond USD 3 billion. A similar transaction can be found at the roots of WNS, which was a BPO spin-off from British Airways’ ticketing centre, again catalysed by Private Equity. "Companies following hybrid (sell-out or dual-sourcing) and sell-out strategies consist 30-35 per cent of the remaining captives," said Apte, as quoted in the Business Standard. These were very large organisations of several thousand employees to start with. Such routes will probably not be available in KPO.
• **Moving from Captive-only to Dual-sourcing 'Captive+Vendor':** Several companies with established but stagnating captives more than 24-36 months old have started dual-sourcing by giving work to one or two vendors. Typically, they use vendors for four reasons:
  
  – **Peak-load absorption** – Instead of adding headcount to their captive, they buy variable capacity from vendors.
  
  – **Complementary services** – Instead of adding new specialist services to their captive and increasing internal complexity, they source complementary services from specialised vendors. For example, Evalueserve provides market research and business research to companies with investment research captives in India.
  
  – **Global support** – Often captives do not have a global footprint, and cannot provide 24X5 services and support for US time zones during US afternoons. Specialised vendors with KPO hubs in the western hemisphere and in China can add these capabilities easily without clients having to set up new undercritical captives. Additionally, this adds language support (Chinese, Japanese, Korean and European languages) as a corollary benefit.
  
  – **Benchmarking the captive against the vendors** – Having realised their captives might be more costly and less productive, some companies have started benchmarking their captives against vendors, an effective way to keep everybody ‘on their toes’.

Companies with captives already in place are not likely to abolish them for two reasons. Firstly, there will always be certain processes companies cannot or are not willing to outsource to vendors, for compliance reasons, for instance. Secondly, western decision-makers who made decisions to set up captives and the senior management of these captives in India do not want to reverse their decisions for obvious reasons.

• **Not Setting up Captives Anymore:** Companies without established captives have started understanding the benefits of working with vendors. Evalueserve estimates the share of companies starting to work with vendors instead of setting up captives to be about 75-85% in 2007, especially in the case of SMEs. Naturally, due to the fact that companies setting up captives are mostly Fortune 500 companies, the number of professionals working in captives will still remain high.

**Shift to vendor model and SME customers driving long-term growth**

According to Evalueserve estimates (Figure 5), 75,000 professionals were working in the KPO industry in 2006. Depending on the scenario, by the end of 2010, this number is likely to increase to about 280,000 in Scenario 1 and 250,000 professionals in Scenario 2, corresponding to an annual growth rate of about 35-40%. Scenario 1 assumes that vendors and captives find enough professionals and have mastered the scalability challenge in Sales. Scenario 2 assumes that fewer captives and vendors have mastered the scalability issue and the recruiting and training challenge. In line with this, the number of western companies leveraging KPO in either a captive or vendor model is likely to increase from about 900 in 2006 to more than 5,000 by the end of 2010, at an annual growth rate of about 50%. This over-proportional growth rate stems from the growth in the SME customer segment.
Evalueserve estimates that in 2006, of a total of about 75,000 professionals working in KPO, approximately 60% worked in captives and about 40% worked for vendors (Figure 6). Interestingly, the vendor model already seems to be the preferred model, mainly due to the high number of SME customers, i.e., companies that would never reach critical mass and have therefore decided to work with vendors. Naturally, such engagements are on average much smaller than captive engagements, translating into a higher number of professionals working in captives.

However, the situation is likely to change dramatically through 2010 (see Figure 7). Evalueserve estimates that in 2010, vendors will add significantly more capacity than captives. This shift is even stronger when looking at the number of companies, where SMEs will dominate, obviously with much
smaller average engagement sizes. This is consistent with the findings in Chapter 1, where KPO follows IT with a time shift of about ten years.

**Figure 7: Net new KPO professionals and share of KPO models used by companies in 2010**

<table>
<thead>
<tr>
<th>Net new KPO Professionals in 2010</th>
<th>KPO Models used in 2010</th>
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<tbody>
<tr>
<td>(Estimates, Scenario 1)</td>
<td>(% share of companies, estimates)</td>
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<tr>
<td></td>
<td>Captive</td>
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<td>Percent share of companies</td>
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Source: Evalueserve Analysis

In the long run, SMEs will be the KPO industry’s main growth driver as most of the Global 5000 companies will have defined and executed their offshoring strategies at some point. However, there are about 5 million SMEs in the US, 1 million in the UK and about 4 million in Continental Europe, representing about half of private-sector employment. Estimates by Evalueserve show that of about 10 million SMEs in the US and Europe, about 5-10% (0.5-1.0 million SMEs) could potentially benefit from KPO services in some fashion. These companies now have easy access to KPO. Continental European SMEs will face lower growth in the case of language-sensitive work due to the limited capacity in non-English KPO solutions. Even assuming very small engagement sizes, the multiplier is so large that KPO work from SMEs will outstrip KPO work from Global 5000 companies.

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About Evalueserve
Evalueserve is a global specialist in knowledge processes with a team of more than 2,600 professionals worldwide. As a trusted partner, Evalueserve analyzes, improves and executes knowledge-intensive processes and leverages its proprietary technology to increase efficiency and effectiveness. We have dedicated on-site teams and scalable global knowledge centers in Chile, China, India and Romania, which provide multi-time zone and multi-lingual services.

Evalueserve’s knowledge solutions include customized research and analytics services for leading-edge companies worldwide. By partnering with us, clients benefit from higher productivity, improved quality, and freed-up management time. We provide our clients with better access to knowledge and information across all parts of their organization, thereby adding to their capabilities.

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Marc Vollenweider, CEO and Co-founder of Evalueserve, authored the Evalueserve paper titled ‘The Future of KPO – Make or Buy’ in April 2007, and provided substantial inputs and insights to the current article.

Marc founded Evalueserve in December 2000, after spending a decade with McKinsey & Co (including two years as a Principal in Switzerland and India). Prior to starting Evalueserve, Marc established McKinsey Knowledge Centre in Gurgaon, India, and grew it from 14 to 120 professionals between 1999 and end of 2000.