

## RESEARCH SUMMARY:

### Total Cost of Offshore (TCO): Understanding The True Offshore Financial Rewards and Costs

By neoIT

**What is the total cost of offshore sourcing and what is the financial reward that enterprises can expect from their global sourcing initiatives?**

**Key issue:** What areas, especially beyond labor costs do enterprises need to consider in order to develop accurate financial scenarios for their global sourcing initiatives?

While labor rates can be 70 to 90% lower in offshore markets, most firms save only 25 to 50% on their global sourcing initiatives. This white paper will help you understand the components that should be considered to arrive at accurate financial scenarios for offshore success.

neoIT recommends that enterprises clearly understand and identify the various components of cost that together comprise the Total Cost to Offshore in order to meet the following objectives:

- Understand the true cost savings expected from the offshore sourcing initiative;
- Measure the relative financial impact of sourcing from different regions, and compare with commensurate risk;
- Appreciate how different trends in the global markets impact cost (not just wage rate fluctuation);
- Plan for appropriate risk mitigation strategies commensurate with location and process risks
- Effectively manage the overall financial impact, by managing holistically, rather than focusing on only one or two obvious components.

## Introduction

Cost optimization is one of the primary objectives companies have in developing a global sourcing initiative. With so much media discussion of the wage rate differences that form the basic leverage in global sourcing, enterprises frequently set expectations of cost savings entirely on wage rate arbitrage. This assumption can easily lead to a false sense of anticipated savings. When companies recognize the prospect of lower savings, they lower investment in appropriate risk mitigation strategies. This sets up the initiatives to fail or not meet expectations.

It is very important to ensure that in pursuit of lower costs, enterprises are realistic about the cost and direct financial benefits of offshore sourcing, and manage all components of cost, not just the one or two obvious ones. There are several components of cost that are inevitable in a global delivery model, and others that are elective, but critical in managing the risk and complexity of the global delivery model.

In neoIT's experience, clients achieve savings ranging from 25%-50% annually over a 3-year period, not 70%-90%, as the pure wage rate differential would suggest. In this article, we take a look at the other components of cost that impact the financial base case for global sourcing. The total of all these costs is called the Total Cost to Offshore (TCO).

Any Financial Base Case analysis of the impact of offshore outsourcing must take into account all the costs associated with an offshore initiative. The Total Cost to Offshore has the following key components:

- 1. Wage Rate**
- 2. Communication Systems**
- 3. Physical Infrastructure and Support**
- 4. Transition**
- 5. Governance**
- 6. Resource Redeployment**
- 7. HR Change Management**
- 8. Training and Productivity**
- 9. Disaster Recovery and Business Continuity Capabilities**
- 10. Offshore Knowledge Development/Advisory Services**
- 11. Travel costs**
- 12. Exchange Rate Fluctuations**

Even though, under typical outsourcing contracts, several of the above components are included within the "charge rates" quoted by service providers, it is important for enterprises to understand the various cost lines in order to negotiate appropriate charge rates, and manage the balance between different cost components. Understanding total cost is also important to ensure that the service providers are adequately budgeting their investment in infrastructure to support the needs of the enterprise.

In the section below, we describe each component in detail.

## Components of Cost

### WAGE RATE

The wage rate differential between countries is the most important cost savings opportunity, and drives the market for offshore sourcing. Wage rates for similar skill sets in different geographies is shown below in Table 1. However, the wage rate is only one of many costs that make up the total. For example, in offshore Call Center Outsourcing, direct labor costs account for less than 30% of the total cost of operations.

**Typical annual salary ranges for offshore professionals**

	Programmer (2-3 yrs. experience)		Call Center Agent (2-3 yrs. Experience)		Programmer AVG.
India	\$ 6,000	to \$ 9,000	\$ 5,500	to \$ 7,000	\$ 7,500
China	\$ 5,500	to \$ 9,600	N/A	N/A	\$ 7,550
Philippines	\$ 6,500	to \$ 10,900	\$ 7,600	to \$ 9,200	\$ 8,700
Russia	\$ 7,000	to \$ 13,000	N/A	N/A	\$ 10,000
Ireland	\$ 21,000	to \$ 28,000	\$ 16,000	to \$ 25,500	\$ 24,500
Mexico	\$ 18,000	to \$ 23,000	\$ 3,000	to \$ 15,000	\$ 20,500
Malaysia	\$ 8,700	to \$ 12,800	N/A	N/A	\$ 10,750
Brazil	\$ 9,000	to \$ 16,000	N/A	N/A	\$ 12,500
Vietnam	\$ 2,850	to \$ 4,100	N/A	N/A	\$ 3,475
Singapore	\$ 27,300	to \$ 34,600	\$ 22,300	to \$ 28,400	\$ 30,950
Canada	\$ 25,000	to \$ 50,000	\$ 18,600	to \$ 28,300	\$ 37,500
United States	\$ 45,000	to \$ 85,000	\$ 25,000	to \$ 40,000	\$ 65,000

**Table 1:** A comparison of wage rates in different countries for similar skills.

**Source:** neoIT

**Note:** Salary range depends on Supplier Tier (1,2 or 3) and City of Operations (tier 1, 2 or 3)

### COMMUNICATION SYSTEMS

Offshore outsourcing requires a significant investment in reliable communication infrastructure. Typical components include leased circuits with enough dedicated bandwidth to carry simultaneous voice and data traffic between countries without latency. Typically, with appropriate compression, a 2Mbps IPLC (IP Leased Circuit) can support a team of 80 simultaneous voice and data channels. In the Application Development and Maintenance space, the number of supported resources can be higher. These costs, while they have come down significantly over the last two years, are still relevant. For example, each IPLC from a POP (Point-of-Presence) in the US to India costs approximately \$6000-\$8000 per month. To ensure business continuity, most organizations need to develop redundant communication links, thereby doubling the investment.

In addition, the offshore facilities need to invest in routing equipment (switches, routers, LAN infrastructure, etc.) to direct the communication lines to each desktop. Since the operating model for offshore deals is based on dedicated VLANs (Virtual LAN), there is an additional cost allocated to the outsourcing contract

The communication costs offshore can be 30 to 60% higher than USA/UK costs. The good news is that the cost of bandwidth is constantly dropping.

## **PHYSICAL INFRASTRUCTURE AND SUPPORT**

The cost of the physical infrastructure and other support is usually an additional redundant cost. In most cases, the offshore outsourcing initiative does not lead to a substantial reduction in the physical infrastructure (buildings, power, etc.) at the enterprise. In the case of offshore (captive, wholly-owned) BPO or Call Center operations, these costs can be substantial. The lease rates of Class A buildings continue to rise amid competition for infrastructure, and most BPO operations require additional expenditure on meals, transport, concierge services, etc. for their employees who need to work at night. These costs are very location specific and vary between locations within countries too.

For more information on the process of setting up captive operations, refer to neoIT's report, ***Captive Ownership Option in Offshoring: Opportunities and Challenges***.

## **TRANSITION**

One of the key components of cost associated with offshore sourcing models (whether they be outsourcing contracts or captive operations) is the cost of transitioning from locally deployed to globally deployed operations.

A typical transition timeline for an Applications Outsourcing project is 3-4 months. BPO Outsourcing contracts take anywhere from 5-7 months for the first process outsourced to complete transition. This is the time between a signed outsourcing contract and achieving steady state operations at the outsourcer or captive center. During this time, there are several tasks that need to be completed:

- Development and transfer of documentation
- Detailed transition requirements analysis
- Development and implementation of training
- Offshore resource shadowing/reverse-shadowing
- Plan and Readiness for steady state monitoring
- Establishment of Service Level Agreements
- Full Responsibility transfer
- Integration of operations

During this time, all resources need to be in place, additional supplier resources are required for documentation and training. Enterprise resources need to work overtime, and are likely to receive bonuses for that work. All of these costs associated with these tasks can add a heavy burden to the cost of offshoring if the transition is not managed efficiently, or the project does not achieve steady state within the expected timelines.

## **GOVERNANCE**

Similarly, project governance also requires additional resources. Efficient management of the offshore sourcing process can be one of the greatest sink-holes of cost in an offshore initiative. While it appears somewhat obvious, enterprises (especially those embarking on large, complex initiatives) often under-invest in this area. It is very important to ensure that there is a clear and well-articulated process for moving forward with an offshore initiative that covers the lifecycle of the program. All too often, enterprises get caught in 'analysis paralysis' – going around in circles looking for information without a clear understanding of how to use

it. Alternatively, they adopt the opposite 'Ready-Fire-Aim' approach in hopes of achieving a quick-hit and then figuring out what to do next.

Both approaches can lead to significant remedial costs that ultimately get allocated to the offshore initiative. In the former case, the knowledge acquisition cost is much higher than necessary. The latter can lead enterprises to additional sourcing costs or be held hostage by the 'Power of the Incumbency', so common in offshore outsourcing. Power of the incumbency is the bias enterprises have toward their existing service provider.

These resources, primarily those involved in managing the offshore projects, are typically more expensive than project lead resources. In addition, program management resources from the enterprise need to be available frequently at the offshore outsourcer's location. Large enterprises with significant offshore presence develop expatriate resources for this, while smaller initiatives rely on employees to travel frequently. In either case, the cost of resources can be substantial. As a rule of thumb, resources that cost an enterprise \$200K in the US will have a total cost to the enterprise of \$500K on an expatriate basis.

For more information on transition and governance, refer to neoIT's report, ***Offshore Program Management***.

## **HR CHANGE MANAGEMENT**

As the transition to the global delivery model is completed, and organizations enter operational steady state, there is invariably a cost of internal change management. If the enterprise plans to internally redeploy resources there are costs typically related to retraining and redeployment of resources. If layoffs become necessary, costs of severance and assisting in job searches can be a significant component of costs.

In addition to direct resources costs, there are the costs associated with modifying HR plans to reflect the new roles and responsibilities of internal resources. For example, if an Application Engineer's role changes from primary involvement in technology development to vendor management of an outsourced contract, the change will impact compensation structures, HR metrics and require training and development to ensure continued productivity.

## **RESOURCE REDUNDANCY**

Most types of offshore outsourcing deals require a program structure that creates a certain level of redundancy in resource utilization. Since the cost savings from wage rate differentials is high, this redundancy can be ignored as minor. However, it is important to realize that an offshore outsourcing initiative will have a larger number of FTEs than a similar sized initiative managed purely onsite, especially within the first 18 months of a contract.

As the outsourcing transactions get more complex, the redundancy increases, largely due to additional requirements in governance, and retention of core intellectual capital.

As an example, when an offshore applications outsourcing contract is instituted, there are project managers associated with the program, both from the enterprise as well as from the service provider working onsite. Some of the effort of these resources goes to managing the global delivery model itself (culture, communication, performance management, quality assurance, etc.). This is also true for the technical resources, who begin to take on vendor management roles, while their previous technical roles are adopted by the offshore outsourcer.

## **TRAINING AND PRODUCTIVITY**

Among the most important considerations in measuring the Total Cost of Offshoring is the level of productivity of the teams. Drivers of productivity include:

- Level of training of offshore resources on the enterprise's business environment
- Quality of resources available
- Capability of enterprise IS/business managers to manage offshore outsourcing initiatives, and develop comfort with the global delivery model
- Maturity of the communication infrastructure and processes
- Complexity of the program

Each of these can significantly impact the productivity of the resources and thereby dilute the overall cost effectiveness of the delivery model.

It is also important to remember that the productivity of offshore teams will improve over time with experience working on an enterprise's environment. The financial base case models, therefore, must take into account varied productivity levels during beginning stages of offshoring. For BPO/Call Center offshoring this can be as little as 2-3 months. In contrast, Application offshoring will experience a lower productivity level for the for application offshoring.

## **DISASTER RECOVERY AND BUSINESS CONTINUITY CAPABILITIES**

The development of a Business Continuity Plan (BCP) and a Disaster Recovery Plan (DRP) can be a significant additional cost to the initiative. Both include taking regular back-ups in a facility not likely to be effected by any broad force major event. Both also require some built in redundancy in People, Technology and Process. These may be created through a mature sourcing model with multiple facilities, or as an investment in back up facilities and a 'hot-site' in the US.

For a detailed discussion on BCP/DRP for offshore please read neoIT's white paper titled, ***Security and Data Privacy Best Practices in Offshoring***.

## **OFFSHORE KNOWLEDGE DEVELOPMENT/ADVISORY SERVICES**

Finally, enterprises need to tie-in the cost of knowledge acquisition on offshore outsourcing, whether it is independently conducted, or by leveraging industry experts.

Within the cost of knowledge acquisition is embedded the cost of leveraging an external knowledge base for tools, templates, processes and best practices, to help plan, develop and manage their offshore initiatives. This cost item includes the time and effort tied up in internal readiness assessments, portfolio planning, site visits, due diligence of the supply landscape, and contracting.

## **TRAVEL COSTS**

A global sourcing initiative requires substantial travel by various people as the initiatives progress through the offshore/global lifecycle. While many sponsors and process owners may travel during the knowledge phase, the program managers and process leads travel significantly during the transition stage.

International travel can be expensive with business class tickets from USA to India and China ranging from \$4000 to over \$7500 with economy class prices hovering around \$1500. These expenses can add up quickly.

Also, the budget needs to ensure that ongoing team meeting and operations reviews are accounted for.

### **EXCHANGE RATE CHANGES**

Exchange rate changes are often not included in even detailed assessments of cost, however fluctuations in exchange rate can be an important contributor to the overall financial impact. For captive centers and long-term outsourcing contracts, changes in exchange rates are built into renegotiation of wage rates (or charge rates) and other costs. A foreign currency strengthening against the dollar will increase costs, reduce interest among offshore outsourcers to export and in general soften the market for offshore sourcing.

The table below shows a case study that demonstrates the relative percentage of different components of cost on the Total Cost to Offshore.

BPO	% Cost	ITO	% Cost
Wage Rate	42%	Wage Rate	46%
Communication System	5%	Communication System	3%
Physical Infrastructure and Support	17%	Physical Infrastructure and Support	18%
Transition and Governance	8%	Transition and Governance	7%
Resource Redeployment	3%	Resource Redeployment	4%
Resource Redundancy	2%	Resource Redundancy	1%
Training and Productivity	10%	Training and Productivity	9%
Disaster Recovery & Business Continuity	5%	Disaster Recovery & Business Continuity	3%
Advisory Services	2%	Advisory Services	4%
Travel costs	3%	Travel costs	3%
Exchange Rate Changes	2%	Exchange Rate Changes	3%

**Table 2:** Typical percentage breakdown of the Total Cost of Offshore

It is very important to remember that, as stated in the introduction, some of the costs are inevitable in an offshore sourcing initiative, while others are elective yet critical to managing the risk and complexity of the global delivery model. A strong methodology for lowering the Total Cost to Offshore will never try to reduce every component of cost, but manage each holistically to ensure that the overall cost is optimized and commensurate with the level of risk.



Typical ways to reduce the Total Cost to Offshore is presented in the table below:

Component of Cost	Without Real time Offshore Expertise	With Real time Offshore Expertise
<b>Wage Rate</b>	Lack of real time knowledge of wages leads to higher rates, or the sourcing process can be focused only on the expensive top-tier service providers.	Experts with real time knowledge of offshore can typically negotiate better charge rates, identify resources or regions with lower wage rates, and help identify highly effective Tier II service providers without raising acceptable risk profiles.
<b>Communication Systems</b>	Lower investment in Communication systems and infrastructure likely, in order to cut cost leads to frequent outages. Or, overinvestment as a result of lack of market knowledge.	Offshore expertise is useful in identifying the appropriate level of investment and redundancy required to manage offshore initiatives.
<b>Physical Infrastructure and Support</b>	Can be expensive, likely to be an area of under-investment to cut cost.	Advisors are useful in identifying the appropriate level of investment required, based on region and total costs such as transportation etc..
<b>Transition</b>	Projects can take several months to reach steady state and poor resource management can lead to 'reactive' management of the offshore initiative. Missing transition deadlines are common due to inadequate planning, causing higher transition costs.	ADM projects should typically take 3-4 months to reach steady state, while BPO projects should take 5-7 months. Experience in implementing components of transition such as structuring resources, building infrastructure, and developing appropriate training is necessary to mitigate risk and reduce unnecessary costs.
<b>Governance</b>	Poor governance structures can lead to 'reactive' management of the offshore initiative. Several iterations and remedial work while going through the sourcing process is typical of enterprises with limited experience with offshore	Strong governance structure, seeded with location expert resources is imperative in developing a "proactive" monitoring and management process.
<b>HR Change Management</b>	Difficult to manage internally due to lack of change management resources and capabilities.	Advisors and consultants are very helpful in developing and coordinating appropriate redeployment programs as well as structuring layoffs as to minimize morale issues.
<b>Resource Redundancy</b>	A corollary to poor governance structures, enterprise can get too conservative and have high resource redundancy by retaining most of the internal staff in place, or too aggressive and delegate all responsibility of the project to the service provider.	Deep HR and offshore expertise during the planning phase, and then again during the transition and governance phase, will develop the right structure for effectively managing global projects, and thereby manage resource redundancy.
<b>Training and Productivity</b>	Companies tend to underestimate in training to minimize costs and offshore travel.	Suppliers and advisors can help develop a process for training and development of resources that covers both operational and cultural aspects of the global delivery while adapting to each enterprise's business needs.
<b>Disaster Recovery and Business Continuity capabilities</b>	Inadequate investment in BCP/DRP	An area where sourcing advisors typically will add investment to appropriate level for risk management.
<b>Offshore knowledge development/ advisory services</b>	Cost can be significant in terms of time and effort in gathering information, rationalizing disparate data and developing a method for turning information into an actionable program.	Significant offshore knowledge and a proven methodology for taking an initiative from vision to reality is the hallmark of a sourcing advisor.
<b>Travel costs</b>	Paying full fare and encouraging offshore junkets.	Taking advantage of consolidators and other international fare reduction opportunities.



Component of Cost	Without Real time Offshore Expertise	With Real time Offshore Expertise
Exchange Rate Changes	Can impact long-term deals and captive environments	Information on potential directional changes and its impact, and the ability to negotiate longer fixed rates helps enterprises manage this cost.

**Table 3:** Leveraging Real time Expertise to lower Total Cost to Offshore.

## Conclusions and Recommendations

- 1. Invest in Planning.** A structured approach to offshoring that focuses on defining a 3 to 5 year road-map will yield higher returns. Layout a strategic plan to offshoring to avoid long learning curves and redundant efforts.
- 2. Focus on the Total Cost to Offshore.** Wage Rates only account for 35-50% of the Total Cost. Focusing only on the wage rate arbitrage will lead to problems in others areas such as infrastructure and utilization leverage. This results in mismanaged expectation of savings and inadequate risk mitigation plans.
- 3. Manage costs holistically.** Focusing on reduction of only one or two obvious components of cost will not provide all the benefits of offshore sourcing, while trying to cut all costs will lead to increased risk. For example, increased risk may require increased investment in management. Risk and reward need to be managed well.
- 4. Use real time expertise to provide offshore knowledge and process management.** If relevant offshore expertise does not exist internally, consider hiring advisors. The cost is easily recovered by greater savings due to less time spent acquiring offshore knowledge, lower prices, risk mitigation etc..

More information about the offshore outsourcing industry can be found within neoIT's research center at [www.neoOffshore.com](http://www.neoOffshore.com). For more details about neoIT's offshore advisory and management services, please contact:

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