Choosing an Evolutionary Path for Offshore Captive Centers

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Executive Summary

Captive centers are wholly owned near-shore or offshore subsidiaries that provide IT, business process and R&D services to their parent firms. There are four models for captive centers—basic, hybrid, shared and divested. Each of these models is illustrated by a case example in the full article, which provides an understanding of how parent organizations successfully evolve their captive centers into effective long-term solutions for their sourcing needs.

All of the captive centers studied started life as basic centers but have evolved over time into a new form. So the first stage of the evolutionary path is to establish a captive center. Stage 2 is to evolve the captive center to a hybrid center. Stage 3 is to evolve the basic or hybrid center to a shared center, and Stage 4 is to divest the center to a third party.

Basic Centers

A basic captive center provides services only to the parent firm. With such a center, a firm seeks to maintain control over the offshored processes, protect its intellectual property by embedding it in methodologies or processes and benefit from the cost savings offered in the offshore location. Management in the parent firm often perceives a basic center as a cost center that lacks the ability to grow and attract...
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external clients. As such, these centers face two challenges: 1) finding ways to operate lean and securing the cost savings from operating offshore; 2) developing capabilities that will allow them to grow and attract business from external clients.

Hybrid Centers

A hybrid center outsources parts of its own offshored processes to external, often local, vendors. Hybrid centers thus represent a mix between basic captive offshoring and offshore outsourcing. With the hybrid model, the captive center can free up resources to focus on high-value work and reduce costs by outsourcing to a cheaper third-party vendor. Evolving from a basic to a hybrid captive center requires: 1) an insourcing model where third-party providers operate as part of the captive center's team; 2) an outsourcing model where seasonal and short-term project skills are obtained from providers outside the captive center on an as-needed basis. The key challenges faced by hybrid centers are developing sourcing capabilities offshore and ensuring the same (or better) level of service from third-party vendors.

Shared Centers

A shared center provides services to both the parent firm and external clients. Shared centers increase the volume of transactions processed offshore, thus offering better value per transaction. There are two drivers for evolving to the shared model: 1) to increase scale, which means the center will become more competitive as offshore unit-processing costs will decrease; 2) to become a center of excellence in particular business processes. Deciding to evolve toward the shared model is a strategic move that requires the involvement of the parent firm. The captive center will have to be more independent and operate as a profit center to ensure that it can cope with the growth strategy. Challenges faced with the shared model include the level of investment needed to ensure uninterrupted service to the parent firm as the center develops its external client base, and the need to develop offshore marketing and sales capabilities.

Divested Centers

A divested center is one where all or some of a captive center's operations have been sold to a third party. Following divestment, the parent firm in most cases will become a client of the acquired captive center to ensure service continuity. Captive centers are often bought because the buyer believes that the center's value will increase over time (e.g., it may specialize in a high-growth area). The buyer invests in the captive center in anticipation of further growth and segregates the center's operations from other offshore operations it might have. Alternatively, a captive center may be bought by a local vendor that is seeking to integrate the center's line of business processes or IT services with its own portfolio of offshore services. The goal is to improve the range of services offered by the buying party as well as to increase the scale of transactions performed offshore. Apart from the challenge of finding investors prepared to purchase a captive center, the parent firm needs to consider whether to retain a majority stake in the divested center. Once a captive center has been divested, the status of the parent firm changes from an internal consumer of the center's services to an external client of the center.

Advice for Executives

Executives of multinational firms should assess the role that offshore captive centers have in their global strategies. Deciding to establish, expand or divest a captive center is a major decision with long-term implications for the parent firm's operations and the distribution of its capabilities and expertise around the globe.

Captive centers will play an important role in the future service marketplace, gradually becoming more aligned with the parent firm's global strategy. The success of captive centers will depend on the ability of parent firms to support the growth and success of their captive centers and guide their evolution from the basic model to the hybrid and shared models, and then to possible divestment. The full report describes the actions that can be taken to meet the challenges of each evolutionary stage.