Captive vs. Third Party

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Captive vs. Third Party Shared Services

When we read the papers, we see a clear trend emerging. More and more companies that operate captive shared service companies are selling them to third party BPO companies. And many more shared services of captives are on the block such as Fidelity, Franklin and Dell. The list seems endless.

This trend reopens what many thought were settled questions in the shared service versus third-party debate. Which model adds more value to the shareholders and to the firm in the long run? What should be the roadmap?

Evolution

Over the last 15 years in this nascent industry, almost all the companies have made the same journey

1. They started as the back office for mundane/routine transactional activities (Claims Processing, Email Support, Tech Help Desk)
2. They slowly graduated to more value-added activities (Invoice Queues Management, Cash Applications, General Ledger, Fixed Assets, etc.)
3. They were able to move to High-End Analytics, Financial Reporting, Regulatory Filing, etc.

The prevailing operating models are:

1. Captive model
2. Sales/Outsource model - The enterprise sells its shared service center (SSC) to a partner and then outsources that work to the partner

Partner model, shared service centers and the captive model have proven their ability to centralize and normalize operations and improve process efficiency and service levels. However, these models now need to deliver ongoing business value adds through innovations, which is the current demand. Such demands require heavy investment and specialized skill sets. This is where most of the organizations are planning to augment their SSC and captive strategy with third-party outsourcing.
“What creates greater shareholder value?”

Where SSCs still make sense

There are four instances where SSC still make sense for an enterprise. They are best when:

1. There is a need to control the end resolution like intellectual property issues or highly complex activities that require specialized domain knowledge. This is especially true where specialized R&D is involved. Technically these are not shared service centers but rather centers of excellence where residents and expatriates jointly work together on cutting-edge technologies.
2. There is a need for the people doing the work to be employees of the company.
3. There are legal or regulatory restrictions.
4. When the enterprise is uncomfortable outsourcing this to a third-party provider. For example, some banks prefer to own the entire process chain due to data and customer confidentiality.

The need for a third party solution

Buoyed by the initial euphoria around significant cost savings, talent availability and favorable policies, most of the companies joined the shared service bandwagon in the 1990s. However, not many companies were able to realize the full potential of the expected benefits. The key challenges were:

- Economies of scale
- Management bandwidth to manage locations across the globe
- Dedicated technology support to move up the chain faster
- HR issues like managing and retaining employees
- Cost allocation to different legal entities, subsidiaries or corporate divisions

BPO is not a quick-fix solution. Successful companies have based their senior accounting and operations and business folks in India, China, Philippines and other offshore locations to make this work.
Here are some issues to think about:

- **Management bandwidth.** Planning the transfer involves expensive management time spent on gaining, understanding and deciding on the appropriate approach. How do we structure the organization? What are the pricing norms?

- **Fear of head count.** Most shared service locations start with a few hundred employees. But when they enter the rapid growth phase, they are not sure how to handle the few thousand employees in a single location. Questions around things like career planning and role enrichment arise and the companies start facing attrition and poor employee morale.

- **Cost-cutting rationale.** A recent study found only 45% of the shared service centers have “attained the cost improvement goals they had in mind when they visualized the model.” Frequent travel, disproportionate management time, pace of execution and ramp up and costly redesign exercises made setting up a shared service center a daunting proposition.

- **Strategic/Transactional.** Some shared service organizations of multinational companies have stagnated at a few hundred employees even after eight years of existence; they just end up being outposts for redundant personnel. These shared services centers will never be able to take part in any strategic initiatives or contribute meaningfully in the global plan of the parent.

Typically a shared service location takes anywhere between two to three years to grow in size, mature as a delivery center and start aligning itself with the goals of the broader organization.

To sum up, using a third party is the preferred solution today as it provides:

1. Economies of scale
2. Access to technology
3. Access to best practices
4. Employee mobility
5. Cost savings
6. Benefits of specialization
7. Continuous improvement
8. Focus on critical core
9. Transaction pricing model
10. Operational excellence
About Coracall

Coracall is a UK headquartered, full service business process outsourcing company specializing in best in class voice, non-voice, and back office support to global organizations. For further information please contact:

United Kingdom

Ian Allison
Director Call Centre Services
Barnby House, Barnby Gate
Newark, Nottinghamshire
NG24 1PZ
United Kingdom
Mob: +44 7815 046229
ian.allison@coracall.com

South Africa

Ian Kinsey
Managing Director – South Africa
1st Floor, Coastlands Gatemax
329 Umhlanga Rocks Drive
Umhlanga Ridge
Kwa-Zulu Natal
South Africa
Mob: +27 79777 2555
ian.kinsey@coracall.com

Philippines

Patrick David
International Marketing & Sales
Level 37 Orient Square Building
Emerald Avenue
Ortigas. Pasig City
Manila
Philippines
Mob: +639 165139341
patrick.david@coracall.com

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