

Client Alert

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Alternative Offshore Outsourcing Structures

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Offshore outsourcing retains an allure that the growth of hybrid cloud services and service integrator delivery models cannot entirely dispel. Even with the advent of varying alternative outsourcing models, organizations can still achieve significant savings from leveraging the benefits of doing business in a country with a lower cost of living and wage scale. But offshoring comes with strings attached, and neither of the two main approaches - full outsourcing to a local provider or wholly owned captive entity – is a universal solution to negating risk. Thus, organizations continue to seek smarter ways to include offshore services delivery as part of their sourcing strategies, all the while attempting to mitigate risks.

Risk mitigation comes in many forms, but it can start with the earliest, most basic decisions in a sourcing process: What to outsource? What is the optimal structure? Where is the best location? All of these issues must be factored in when making the sourcing decision. This Alert looks at some of the main alternative offshore outsourcing structures – from virtual captive, to joint venture, to “build-operate-transfer” models – and assesses how they compare in terms of benefits, flexibility, regulatory compliance and long-term operational suitability.

In recent years, organizations have tended to see offshore outsourcing as one of a menu of sourcing options, sitting alongside some degree of cloud-based or as-a-service delivery for certain services, or operating as part of an ecosystem of multiple providers managed in whole or in part under a service integrator and management (SlaM) regime. While one might have expected both cloud and SlaM methodologies to have eroded the use of offshore services, our experience is that the offshore market has adapted and evolved to fit within whatever structure is most prevalent, and we currently see an increasing trend to re-consider offshore models that, 5 years ago, seemed potentially to be moving into a backwater.

CAPTIVE OR FULL OUTSOURCE

Traditionally, organizations looking to send services offshore consider two main options: either they do it themselves, probably by setting up a “captive” entity in the chosen country or they engage a third party specialist to do it for them by entering into an offshore outsourcing contract.

Both models – the Captive and the Full Outsource – have their pros and cons. The Full Outsource means putting your company and some of its key services in another company’s hands. You may be comfortable with this if the service provider is based in a country from which outsourced services have historically been provided and which has the infrastructure to sustain the services being offered, and/or if the service provider is a well-known global name with a proven track record. It becomes a riskier proposition if the organization is outsourcing to a country where the laws, infrastructure, experience and practices are less mature, or to a provider that is less established.

Equally, the issues with a Captive model stem from the fact that the organization is required to provide services back to itself via a ring-fenced entity that is more or less free-standing and self-financed. This can have short-

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term control benefits as well as long-term investment benefits, and a few companies have used Captives to go offshore and ended up lucratively selling off the captive entity (prominent India-origin service providers Genpact and WNS started this way, for example).

But the Captive model is less suitable for first-wave outsourcings and really requires a customer that already knows the offshore market and how to operate there, and that is potentially willing to make a substantial investment of time and money in the jurisdiction. Many companies have felt that they don't have that knowledge and don't want to incur the risks of the Captive route, on the one hand; but on the other hand nor do they want to go to the other extreme and send all of their services to a third party via an arm's-length Full Outsource.

Therefore, organizations have sought out hybrid models with elements of the benefits of a Captive (e.g., in terms of control and governance, the local service provider's inherent skills and knowledge of how to operate offshore, and the opportunity to up-skill offshore operations management), but which don't involve simply putting one's entire faith and trust in a single offshore provider.

The growth of cloud-based and SlaM cross-tower sourcing approaches has added a new dimension of complexity and subtlety to the sourcing decision. Processes developed to manage cloud-based service provision within an organization's sourcing strategy don't automatically translate to effective management of hybrid offshore structures; whereas a well-selected SlaM provider may provide for an effective means of managing offshore options. When making the sourcing decision, the organization must have the ability to manage itself or through a third party the differing forms of service delivery, with each sourcing type requiring different management and oversight skills.

BUILD-OPERATE-TRANSFER

A concept familiar to project finance and major infrastructure projects, the first hybrid offshore model to gain traction was the "build-operate-transfer" (BOT) model. The BOT model developed as a hybrid that inhabits the space between Captive and Full Outsource. As its name suggests, the BOT model involves the customer engaging a third party expert to set up the local entity, resource it, run it for a specified number of years and then transfer it back to the customer.

The BOT model enables the outsourcing customer to share the risk with the offshore service provider that sets up and operates the local operation. The customer effectively pays for someone else to do the dirty work of building the house and then just moves in once all of the construction, decoration and furnishing is complete. Generally, the customer pays an operating fee and then a buy-out fee at the end. However, it is possible to set these structures up with varying alternative methods of front-end financing and back-end exits. For example, the arrangement may call for the customer sharing in the up-front investment, thus reducing the asset acquisition costs to the customer on the back-end. It's also possible to structure the arrangement so that the customer has the option to call for a transfer of the operation at any time during the operation. It is even possible to structure the arrangement where the customer can walk away at the end (although structurally and financially that would look more like a regular Full Outsource model than a BOT deal).

One issue with BOTs is assessing in advance what the buy-out payment ought to be (*i.e.*, determining an accurate valuation of the transferable asset). Also many of the large and well-respected native offshore providers

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(especially in India) became increasingly less willing to devote extensive resources (and their A grade people) to setting up and running a BOT entity for a customer because their efforts were rewarded with an adverse economic result; the better the service provider did in the “build” phase, the more likely it would be that the purchase option would be exercised, and the entity taken in-house (or, worse still, bought but handed over to a competitor to run). The service providers didn’t get the long-term benefit of building and operating an efficient operation because the customer was able to acquire it at its most profitable phase.

Interestingly, having seemingly gone out of fashion for a while, we see a recurrence of interest in the BOT model, spiked by the SlaM model – either directly because a SlaM provider potentially provides skills and management to de-risk BOT to an extent, or indirectly because some of the native offshore providers perceive reviving BOT offerings as a way to reinvigorate direct offshoring relationships.

VIRTUAL CAPTIVE

From the mid-2000s onwards, the concept of a Virtual Captive model began to emerge as an alternative hybrid for the operation of an offshore outsourcing arrangement. One of the first deals in relation to which the term was used was a BPO deal between Wachovia, a U.S. National Bank, and Genpact in 2005, which involved Genpact providing a dedicated center, resources and supporting infrastructure to provide services and support to Wachovia’s back office business processes across the world. Wachovia in turn retained some element of control over the offshore operation, including with respect to such issues as the hiring and retention of employees.

The distinctive feature of a Virtual Captive is that there is more sharing of risk between customer and service provider than in either the Captive or the BOT model. In many ways, it is closer to a joint venture than to a BOT or a Captive; although, of course, the use of the customer’s branding to “badge” the Virtual Captive makes it look like a Captive operation.

For the customer, a Virtual Captive has the benefit that it has engaged a local expert who manages the operation and has the local on-the-ground expertise in order to do so. But it also gives the customer more control over day-to-day operations than a BOT (in respect of which the customer’s control is really at the point of exit rather than based on day-to-day management and performance).

Generally, the benefits of a Virtual Captive solution include:

- leveraging the on-the-ground resources and expertise of the partner to attract and maintain top talent but, at the same time, meeting the client’s needs for organizational control (which doesn’t exist in a BOT model);
- better addressing the client’s regulatory and risk issues (which is perhaps why Virtual Captives are commonly associated with the financial services sector where the extra degree of customer control makes it easier to satisfy regulators in the customer’s home country); and
- flexible structuring, *i.e.*, there’s no “one size fits all” universal template for a Virtual Captive, so it can be structured to cherry-pick the benefits of other models.

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Specifying exactly what a Virtual Captive looks like is difficult. Like a joint venture, it is a flexible model that can be created in many different ways. But issues which might distinguish a typical Virtual Captive would be:

- **Nature of the Relationship.** In a Virtual Captive, the service provider acts as more of a service manager, and the relationship with the customer is established accordingly. It is less arm's-length and more intertwined; although it remains in both parties' interests to have clearly delineated responsibilities.
- **Branding.** Although precise branding is optional, Virtual Captive operations are typically branded with the customer's own name, although with some credit to the service manager. The precise extent of "white labelling" will vary in each case, of course.
- **Pricing.** Pricing will be fully transparent throughout the agreement rather than being open-ended (as it would be in relation to a Captive) or negotiated on the commercial market (as it would be for a Full Outsource or a BOT). BOT pricing is typically closer to the Full Outsource model; although with back-end option and asset acquisition payments. Virtual Captive pricing would be characterized by "streaming" of different cost elements, starting with the negotiation of an enterprise management fee for the service manager and then moving on to separate payment streams corresponding either to individual operational aspects of the agreement or to specific fixed/variable cost elements. Customer and service manager would expect to be responsible for different slices or bands of the cost base, obviously with a profit element for the service manager reflecting its risk and built-in incentives designed to encourage cost and productivity management.
- **Service Delivery.** Obviously in a Captive, the customer bears sole responsibility and risk for service under-performance. In a BOT, this risk remains with the outsourced service provider that's running the BOT (and, as noted above, the incentive is for the service provider to do not so badly that the customer exits, but not so well that the customer exercises its option to buy-out). In a Virtual Captive, service delivery risk is handled in a more cooperative way and the service manager operating the Virtual Captive would expect both specific and general inputs from the customer in relation to risk mitigation and service delivery. Specific service-affecting activities (e.g., regulatory risk) may be managed by the customer rather than the service manager or, at least, key governance roles or committees may be partly customer-populated.
- **Staffing.** In a Captive, the customer would bear full responsibility for recruitment and retention of staff. In relation to a Full Outsource or BOT model, this remains a task for the service provider, perhaps with some level of customer control over key personnel. In the Virtual Captive model, the customer would make use of the service manager's local expertise and the service manager would take prime responsibility for hiring local staff. However, the customer would expect to set hiring criteria and have more detailed involvement in personnel management. Keep in mind that the operation to which the staff are being hired will likely be branded with the customer's name, even if the actual employment relationship is not with the customer itself.

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- **Governance.** A Virtual Captive requires more extensive governance than a BOT or Full Outsource, but less than a Captive. Joint strategic and operational oversight is important. But that governance provides the customer with a greater insight into the operation, and thus with a greater ability to make decisions around the running of the Virtual Captive operation. In performance management terms, from a customer's perspective, the Virtual Captive is managed both organizationally (as a Captive would be) and through the levers of service levels (as a BOT or Full Outsource would be). The governance model and relationship should be defined up-front and is more complex than in a more linear BOT or Captive model. It is important to identify and understand how all levels of the governance model (from executive or board-level engagement, to line management infrastructure, to day-to-day operational oversight) operate.
- **Operating Risk.** In a Virtual Captive, the customer would expect to share some element of the risk and any resulting losses and/or costs of the operation up to an agreed upon level, maybe set by historical or trend analysis. The service manager would absorb risk, losses or costs above that level. Compare this to the Captive, where all risk falls on the customer, and the BOT or Full Outsource where the risk falls completely on the service provider.
- **Termination.** Obviously, in relation to a Captive, the customer bears all costs and risks of dismantling and re-transitioning operations. In a BOT, this is clearly laid out in an identified way, with costs and responsibilities associated with termination clearly delineated. A Virtual Captive is more closely aligned to the BOT model, though without the balloon payment at the end for the exercise of the right to buy. Note, however, that there may still be exit and transition payments at the end of a Virtual Captive, as there would be in any Full Outsource situation.

Additionally, establishment of a Virtual Captive requires a number of practical decisions, such as whether the Virtual Captive should be established as a separate entity in law in the local jurisdiction. This may lead on to consideration of tax treatment and capital allowances permitted under local law.

CONCLUSION

While the landscape of the sourcing world changes, some of the familiar structures continue to be used by customers and service providers. When making the sourcing decision, customers must factor in many considerations, including risk tolerance, up-front investment costs, exit costs, knowledge of the country environment (including technology maturity and the friendliness of the legal environment), degree of control over operations desired by the customer, etc. The various models provide different options for consideration.

The Virtual Captive shares some benefits with a Full Outsource and some benefits with a Captive operation. For example, it offers lower up-front financial risk than a Captive, since the service manager takes some of the burden of initial investment. But it's the flexibility and opportunity for innovative structuring which appeals to many customers.

Sceptics points out that many of the benefits of a Virtual Captive can also be achieved through the BOT model, e.g., in terms of "dipping the toe in the water" of offshoring without exposing the organization to the full risk of

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doing so. But compared to many of the other hybrid offshoring models, a Virtual Captive is also regarded as a model which provides greater control, visibility and an opportunity for the customer to learn.

It is generally seen that there is an enhanced value proposition available through the Virtual Captive model in terms of its ability to take all of the benefits of an offshore operation and tap into the service manager's skill while at the same time allowing the customer have a greater degree of control over offshore operations and operational input into their success or failure. Customers who perceive this as a way of getting used to offshore operations will also see this as more of a benefit than a BOT model which – until the time of exercise of the right-to-buy option – is much more of a hands-off model.

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