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Alternative Offshore Outsourcing Structures

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In these troubled times, offshore outsourcing retains an allure for businesses. There are still significant savings to be attained from leveraging the benefits of lower offshore operating costs. But offshoring still comes with risks attached and neither of the two main approaches - full outsourcing to a local provider, or wholly-owned captive entity - is seen as a universal panacea. So, increasingly, companies are looking for smarter ways to access the offshore market while mitigating risks.

Risk mitigation comes in many forms, but it can start with the earliest, most basic decisions in an outsourcing process: that is, how to structure an offshore relationship to reduce risk. This article 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 and long-term operational suitability.

Traditionally, companies looking to send services offshore consider two main options: 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. Of course, India has led the way as a number of Indian companies have grown into large global businesses by tapping into the desire for, and benefits of, offshore outsourcing.

CAPTIVE OR FULL OUTSOURCE

Both models – the Captive and the Full Outsource – have their pros and cons. The Full Outsource means putting yourself and some of your key services into another company's hands. You may be comfortable with this if the service provider is based close by or in the same country or is a well-known global name, but it takes more trust and more relationship governance to make that work in a foreign country where you might not fully appreciate all the inherent risks.

Equally, the issues with a Captive stem from the fact that the company provides service back to itself via a ring-fenced entity that is more or less free-standing and self-financed. This can have short-term control benefits as well as long-term investment benefits, a few companies have used Captives to go offshore and have ended up lucratively selling off the Captive (e.g., GE created and spun-off GECIS (now Genpact) and British Airways spun-off WNS).

But the Captive model really requires a customer that already knows the offshore market and how to operate there. Many companies have felt that they don't have that knowledge and don't want that risk – but nor do they want to go to the other extreme and send all their services to a third party via an arm's-length Full Outsource.

And so the search has been on for hybrid models part-way between Captive and Full Outsource that offer some of the benefits of a Captive in terms of control and governance, tap into the local service provider's inherent skills and knowledge of how to operate offshore, allow customers to up-skill in offshore operations management, but don't involve simply putting one's entire faith and trust in a single offshore provider.

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BUILD-OPERATE-TRANSFER

As a concept familiar from 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 the construction, decoration and furnishing is complete. Generally, the customer pays an operating fee then a buy-out fee at the end. It’s possible also to pay some of the up-front capital costs or the asset acquisition costs, and also to structure the arrangement so that the customer has the option to call for a transfer of the operation at the end (or at any time) or simply to walk away.

One issue with BOTs is assessing in advance what the buy-out payment ought to be and in accurate valuation of the transferable asset. Also, large and well-respected native offshore providers (especially in India) are increasingly less willing to devote extensive resources (and their A-grade people) to setting up and running a BOT entity for a customer where it’s perceived that the better the service provider does in the “build” phase, the more likely it is that the option will be exercised and the entity will be taken in-house (or, worse still, bought but handed over to a competitor to run).

VIRTUAL CAPTIVE

From the mid-2000s onwards, the concept of a Virtual Captive began to emerge as an alternative hybrid model for the operation of an offshore operation. One of the first deals in relation to which the term was used was a BPO deal between U.S. national bank Wachovia and Genpact in 2005 that involved Genpact providing a dedicated centre, resources and supporting infrastructure to provide services and support at Wachovia’s back-office business processes across the world. Wachovia in turn retained some element of control over the offshore operation and in issues such 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 of engaging 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 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 organisational 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

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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.

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. And, in many cases, features can vary significantly depending upon individual circumstances and what a customer wants to get out of its hybrid offshore structure. But issues that might distinguish a typical Virtual Captive, BOT or other hybrid model 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 often closer to the Full Outsource model – although with back-end options and asset-acquisition payments. Virtual Captive pricing would be characterised 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 incentivisation built-in to encourage cost management by the service manager. A key factor in hybrid offshore outsourcing is the degree of flexibility and asset-sharing allowed. A hybrid structure in which the service provider must dedicate people exclusively to the customer (so that if the customer doesn't bring the BOT business, those assets sit idle) will be more expensive than one where the service provider can leverage at least some of the people to work on other customers' deals. So, in that latter case, a customer can ask supplier to share more financial risk. It is a matter of negotiation as to the extent to which the service provider can use shared facilities and resources.
- 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 is 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 co-operative 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.

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- 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 hire criteria and have more detailed involvement in personnel management. After all, the operation to which the staff are being hired will be branded with the customer's name even if the actual employment relationship is not with the customer itself.
- Governance. A Virtual Captive requires more extensive governance than a 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 organisationally (as a Captive would be) and through the levers of service levels (as a 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. Customers' approaches to BOT models vary but the general best practice is that in a BOT the customer also needs to devote a lot of management energy to the BOT since it wants an experienced team in place when the transfer occurs. For either BOT or Virtual Captive to be successful, a customer needs to devote substantial management resources to the operation.
- 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 level, maybe set by historical or trend analysis. The risk-sharing element comes in the service manager absorbing additional risk, losses or costs above that level. Compare this to the Captive where all risk is for the customer, and the BOT or Full Outsource where the risk is for the service provider.
- Termination. Obviously, in relation to a Captive the customer bears all costs and risk of dismantling and re-transitioning operations. In a BOT, this is clearly laid out in an identified way with a clear buy-out timeline and, if the contract is good, clear pricing. A Virtual Captive has traditional termination and, exit provisions that one would see in a Full Outsource - perhaps with a right to give offers of employment upon termination, though does not share the BOT balloon payment at the end for the exercise of the right to buy. A key issue with any exit and termination offshore, however, is likely to be in relation to employees and how to force the employees to stay with the Virtual Captive or BOT (or sign up with the entity that acquires the BOT assets) upon transfer?

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

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

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investment. But it's the flexibility and opportunity for innovative structuring that appeals to many customers.

Sceptics point 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 organisation to the full risk of doing so. But, compared to many of the other hybrid offshoring models, a Virtual Captive is also regarded as a model that provides greater control, visibility and an ability for the customer to learn.

It is generally considered that there is an enhanced value proposition available through the Virtual Captive model in terms of its ability to take all the benefits of an offshore operation and tap into the service manager's skill while at the same time allowing the customer to have a greater degree of control over the offshore operations and operational input into their successes or failures. 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.

And finally, of course, there are a great number of variations on the hybrid models. Companies may choose to cherry pick key elements of different structures to come up with their own new varieties, perhaps by entering into a standard Full Outsource but then taking BOT principles and extensively negotiating the end-of-term provisions to allow the operation to be flipped into a Captive at the end of the term. Such a device might be seen by some as a Frankenstein's Monster or by others as a neat way to use clever up-front negotiation to obviate the more onerous and extensive on-going management that a BOT or Virtual Captive might entail.

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